

**EQUITY'S DOMAIN: RISK, MONETARY  
TRANSACTIONS AND INSOLVENCY  
ADMINISTRATION**

**BY**

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## **DECLARATION**

I declare that all sources of this thesis have been acknowledged and that the thesis is my own original research and my own composition.

A handwritten signature in black ink, reading "Fiona R. Burns". The signature is written in a cursive style. Below the signature is a dotted line.

Fiona R. Burns

December 1998



*This thesis is dedicated to my dear parents,  
without whose love and encouragement,  
this work would not have been possible.*

*There are victories*

*of the soul*

*and spirit.*

*Sometimes,*

*even if you lose*

*you win.*

Anon

(Intrinsic. By Design © 1996)

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I have generally followed the *Australian Guide to Legal Citation* (Melbourne University Law Review Association Inc, Melbourne, 1998).

The use of one form of pronoun is not to be construed as anything other than a convenient method of expression. References to one gender should be read as inclusive where the context so requires.

The thesis is based on materials available to me up to 1 November 1998.

## ABSTRACT

This thesis is concerned with how and when proprietary relief ought to be available in certain commercial situations. The task of the thesis is to contribute to the ongoing debate whether and on what basis proprietary relief ought to be available beyond settled traditional categories.

Traditional proprietary rules and methodologies are no longer capable of providing a logical basis for determining when proprietary relief is appropriate in the receipt and collection of money in commercial transactions. Such rules were developed in earlier commercial times when commercial transacting was slower and less sophisticated than today. In recent times, money, that quintessential commercial commodity, has undergone metamorphosis from a tangible physical object to an essentially ephemeral electronic impulse. Indeed, in the light of these developments, it is argued that the traditional proprietary base requirement encapsulated in common law following and equitable tracing is becoming increasingly impractical to meet. Therefore, it is suggested that we should abandon the restrictions associated with the proprietary base requirement. This was presaged by the 'swollen assets theory' which operated in some jurisdictions in the United States during the Great Depression. Moreover, the weakness and limitations of manipulating traditional proprietary relationships such as the trust, fiduciary obligations or subrogation, in an ad hoc way in order to achieve a desired result, are highlighted. Instead, it is necessary to return to and develop a modern explanation of equitable proprietary intervention.

As courts have become more willing to intervene in commercial relationships, equity has been an important instrument in commercial intervention, particularly where proprietary relief is involved. Equity continues to base its intervention on the identification and remedy of unconscionable conduct of various forms. However, in recent times the intervention of equity's provision of proprietary relief in commercial relationships has been explained on the basis that a party did not assume the risks associated with the commercial transaction (particularly the status of an unsecured creditor) because of the insolvent's unconscionable conduct. Contrary to the contentions of common law lawyers (particularly some modern restitution lawyers), equity can and does operate on a principled basis.

The concept of non-assumption of risk is the starting point for the development of a theory of when a court exercising equitable jurisdiction ought to intervene in

commercial relationships. The concept of non-assumption of risk is not only used in the thesis to explain a variety of traditional equitable relationships and remedies, but also as a basis for a theory of objective non-assumption of risk which would apply in situations where proprietary relief has not been readily available in the past. Under the theory of objective non-assumption of risk, the unconscionable conduct of the insolvent which has led to a creditor's unsecured status is remedied. As a proprietary base would no longer be a pre-condition to equitable relief, it is argued that a general equitable lien would be an appropriate form of remedy where non-assumption of risk had been proved. Whether the general equitable lien would extend to assets subject to a floating charge or encumbered assets is still to be resolved, although there are sound policy reasons both for and against the imposition of a lien in such circumstances. It is likely that, notwithstanding the establishment of objective non-assumption of risk, an insolvent's administrators would still have certain defences open to them and some of the kinds of defences which may be available are discussed and evaluated. The theory of objective non-assumption of risk is a natural progression and outcome of the continuing breakdown of the divide between personal and proprietary relief.

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## **Chapter 1**

### **INTRODUCTION: HISTORICAL AND CONTEXTUAL MATTERS**

## I INTRODUCTION

One of the most difficult issues facing the commercial and insolvency lawyers of the late 20th century is ascertaining and defining the circumstances in which a proprietary remedy will be available to aggrieved unsecured creditors in insolvency situations.<sup>1</sup> There needs to be a comprehensive and systematic review of this issue, otherwise the area will continue to be both contentious and uncertain. It has been recognised that the law is still in a formative stage.<sup>2</sup> Therefore, it is not surprising that there have been some recent interesting and helpful responses to the challenges of proprietary relief in commercial and insolvency situations.<sup>3</sup> This thesis is another contribution to the ongoing debate and an attempt to provide a systematic approach to the issue of proprietary relief and remedies in commercial transactions.

The problem addressed in this thesis is difficult from both practical and theoretical perspectives. A has money which B claims as his own. There would be no significant difficulty where A is solvent. B may bring a personal action or a claim in personam to reclaim an amount equivalent to the amount in dispute. However, if A is insolvent, then B is faced with a terrible dilemma - whether or not B has a proprietary interest in the money or an alternative security for the money. If B does have a proprietary interest in the money, in the monetary value or an alternative

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<sup>1</sup> See for example Millett J's comments in 'Reviews and Notices' (1995) 111 *The Law Quarterly Review* 517, 518.

<sup>2</sup> *Re Goldcorp Exchange Ltd (In Receivership)* [1995] 1 AC 74, 104 (Lord Mustill).

<sup>3</sup> See for example Jeffrey Davis, 'Equitable Liens and Constructive Trusts in Bankruptcy: Judicial Values and the Limits of Bankruptcy Distribution Policy' (1989) 41 *Florida Law Review* 1; Emily L Sherwin, 'Constructive Trusts in Bankruptcy' [1989] *University of Illinois Law Review* 297; David M Paciocco, 'The Remedial Constructive Trust: A Principled Basis for Priority over Creditors' (1989) 68 *The Canadian Bar Review* 315; WMC Gummow, 'Unjust Enrichment, Restitution and Proprietary Remedies' in PD Finn (ed), *Essays on Restitution* (1990) 47; John Glover, 'Equity, Restitution and the Proprietary Recovery of Value' (1991) 14 *The University of New South Wales Law Journal* 247; Peter BH Birks, 'Restitution and Resulting Trusts', in Stephen Goldstein (ed), *Equity and Contemporary Legal Developments* (1992) 335; Paul Finn, 'Constructive Trusts - A New Era, Equity Commerce and Remedy' (Paper presented at the 1993 New Zealand Law Conference, Wellington New Zealand, 2-5 March 1993) vol 1, 203; Charles Mitchell, *The Law of Subrogation* (1994); Peter Birks 'Establishing a Proprietary Base' [1994] *Restitution Law Review* 83; Peter Birks, 'Proprietary Restitution: an Intelligible Approach' (1995) 9 *Trust Law International* 43; A Oakley, 'Proprietary Claims and their Priority in Insolvency' (1995) 54 *The Cambridge Law Journal* 377; William Swadling, 'A New Role for Resulting Trusts?' (1996) 16 *Legal Studies* 110; Sarah Worthington, *Proprietary Interests in Commercial Transactions* (1996); Peter Birks, 'Trusts Raised to Reverse Unjust Enrichment: The *Westdeutsche* Case' [1996] *Restitution Law Review* 3; Robert Chambers, *Resulting Trusts* (1997); Malcolm Cope, *Proprietary Claims and Remedies* (1997); AJ Oakley, *Constructive Trusts* (3<sup>rd</sup> ed, 1997); David M Wright, *The Remedial Constructive Trust* (1998).

security (such as a mortgage over A's land), then B is effectively a secured creditor and stands ahead of all other unsecured creditors subject to a few statutory exceptions.<sup>4</sup> However, if B does not have a proprietary interest in the money or does not have an alternative security, then B will stand *pari passu* with all the other unsecured creditors. This thesis focuses on developing a systematic approach to determining when an otherwise unsecured creditor ought to be afforded an effective proprietary and priority status.

It will be argued that traditional methods of creating proprietary interests and evaluating the existence of proprietary interests are helpful but are no longer adequate in the modern commercial world. New ways of dealing with the creation and evaluation of proprietary relief need to be developed. However, such a developmental process should proceed on a historical and contextual understanding of why the law has operated in the way that it has. In the forefront of such an understanding will be the law of equity and the principles which underlie its operation. The reason is both apparently simple and profound. The various mechanisms (most notably the trust and the lien) which have been used to prioritise the interests of otherwise unsecured creditors have been the creations of equity. It will be argued throughout that such mechanisms should not operate separately from the fundamental equitable principles from which they arose. Thus, as the title of the thesis indicates, the resolution of the problem of when otherwise unsecured creditors should acquire a proprietary interest and consequential relief, is equity's domain. Unless this is recognised, the law will continue to be contentious and uncertain.

In order to develop a systematic approach to the problem of proprietary and priority relief in commercial insolvencies, it is necessary to sketch the context in which the commercial insolvencies arise and define the various phenomena which operate within and respond to the commercial context.

## **II THE NATURE OF THE COMMERCIAL TRANSACTIONS: TRANSFER AND RECEIPT**

The first contextual component in the thesis is the basic nature of the commercial transactions which frame the discussion. There are two modes of dealing with money where proprietary claims and interests are involved, namely transfers and receipts. Transfer situations occur where A transfers money to B. The reasons for

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<sup>4</sup> For example, *Bankruptcy Act 1966* (Cth) s 109 (1).

the transfer vary depending on the relationship and the commercial transaction. Receipt cases occur where B acts for and on behalf of A. A third party, C, transfers money to B for and on behalf of A. The receipt can be simply a straight receipt by B. On the other hand, the receipt of funds from C may be funds received from the sale of A's asset. B has acted as an agent for and on behalf of A in the sale transaction. The kinds of situations in which proprietary interests are claimed or where proprietary relief are sought in commercial situations can be divided into four major categories. First, there are the situations where the moneys are transferred for a use in a particular situation only and that particular situation does not eventuate. Prior to the event occurring, the recipient of the money becomes insolvent. The question is whether those moneys should form part of the assets of the insolvent.<sup>5</sup>

Secondly, there are those cases (which can be seen as a variation of the first mentioned) in which a large transaction (sometimes an ongoing one) is built on certain fundamental assumptions, which prove to be either entirely or in part erroneous.<sup>6</sup> Prior to the wrongly held assumption or error being discovered, funds are transferred to the recipient. Subsequently, the recipient becomes insolvent and the wrongly held assumption or error is discovered. The question is whether these moneys should form part of the assets of the insolvent.

Thirdly, situations arise where money is neither transferred for a specific purpose nor as part of an ongoing commercial transaction. Rather, the actual circumstances surrounding the transfer of the money call into question whether the moneys should form part of the assets of the insolvent. For example, do the circumstances surrounding the transfer indicate that the actions of the transferor were truly voluntary? Or did the transferor fully understand the commercial circumstances in which the transfer took place?<sup>7</sup>

Fourthly, there are those situations where there is no transfer of moneys. Rather, party B receives money for and on behalf of another party, A. Generally B is acting as an agent of A. However, after the receipt, but before accounting to A, B

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<sup>5</sup> For example, *Barclays Bank Ltd v Quistclose Investments Ltd* [1970] AC 567.

<sup>6</sup> For example, *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] 2 AC 669.

<sup>7</sup> For example, *Westpac Banking Corporation v Savin* [1985] 2 NZLR 41.

becomes insolvent. The question is whether those funds should effectively form part of the assets of A for distribution amongst B's creditors.<sup>8</sup>

This thesis is an attempt to develop a modern, rational and coherent basis for determining when an aggrieved creditor is entitled to argue that he has a proprietary or prioritised interest ahead of other unsecured creditors. In so doing, these different kinds of situations are not analysed separately. Rather, the object of the thesis is to show how equity does and can respond to them in a coherent way.

### III THE MEANING AND FUNCTION OF MONEY

The second contextual component is money. This thesis is actually concerned with proprietary interests and relief in relation to money rather than a wide array of property (although in Chapter 2 the operation of equitable proprietary relief and interests is considered generally). It is submitted that the changing nature of money in our modern economy has been a principal reason why the issue of proprietary relief has become important in recent times. Therefore, an examination of monetary dealings is appropriate and timely.

Having limited the thesis to dealings with money, it is necessary to understand in both a practical and legal sense the way that money operates. The starting point for such a discussion of dealings with money is the nature of money itself. It may seem an unusual starting point. But, it is surprising to realise that many of the cases which will be considered throughout this thesis<sup>9</sup> do not examine the fundamental nature of money as a prelude to any decision concerning disputes about it. One commentator has noted:

The troublesome question, What is money? has so constantly engaged the minds of economists that a lawyer might hesitate to join in the attempt to solve it. Yet the true answer must, if possible, be determined. For 'money answereth all things.'<sup>10</sup>

In *Halsbury's Laws of England* it is stated that:

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<sup>8</sup> *Walker v Corboy* (1990) 19 NSWLR 382.

<sup>9</sup> For example, *Theiss Watkins White v Equiticorp Australia Ltd* [1991] 1 Qd R 82 and *Barclays Bank Ltd v Quistclose Investments Ltd* [1970] AC 567.

<sup>10</sup> FA Mann, *The Legal Aspect of Money* (5<sup>th</sup> ed, 1992) 1 citing *Ecclesiastes* 10:19.

The primary function of money is to serve as a medium of exchange, and as such it is accepted without question in final discharge of debts or payment for goods or services. Money also serves as a common standard of value by reference to which the comparative values of different commodities are ascertained, as a unit of account in which debts and liabilities are expressed, and as a store of value or purchasing power.<sup>11</sup>

In relation to dealings with money, it has been noted that:

The law has not been prodigal in its thinking about money. Its utility as a medium of exchange, its lack of 'earmark,' and its regular metamorphoses in the ordinary operations of the banking system all contribute to the acute and often unanalysed difficulties which can arise when a trust is sought to be imposed on a particular sum said to be received, held, or controlled by a person for another's benefit.<sup>12</sup>

The analysis presented in this thesis endorses the view that there are many 'unanalysed difficulties' in relation to our handling of money in its modern form. It is submitted the failure to understand money and how it operates has led, in part, to the uncertainty and confusion in cases where proprietary relief has been sought.

Historically, money has taken many guises and has undergone a number of changes in its form. What is important in the context of this thesis is that the physical nature of money has changed. We are now faced with the reality that, in many transactions, money does not take a physical form at all. The rules which have been developed by the courts do not adequately take into account this fact. The evolution of money as we know it today was a complex process. A brief historical analysis is appropriate because the forms which money has taken in the past have influenced the legal rules.

### *A History of Money*

In ancient times, money was not a separate system of coinage or paper. Rather, commodities were used as money.<sup>13</sup> Indeed, the Latin word for money,

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<sup>11</sup> T Michael Ashe, 'Money' in Lord Hailsham of Marleybone (ed), *Halsbury's Laws of England* (4<sup>th</sup> ed, 1973) vol 32, [101].

<sup>12</sup> Finn, *Fiduciary Obligations* (1977) [209].

<sup>13</sup> For a full account of the trading in ancient times, see P Einzig, *Primitive Money* (2<sup>nd</sup> ed, 1966).



*pecunia*, is derived etymologically from the Latin word for cattle, *pecus*.<sup>14</sup> It has been noted that money lacked 'earmark'.<sup>15</sup> Earmarks were used and continue to be used as a means of identifying and separating domestic animals as fungible items.<sup>16</sup> Commodities had 'intrinsic utility and use-value'.<sup>17</sup> Moreover, they were fungible in nature - that is a thing of the same or another class could be delivered in lieu of them.<sup>18</sup>

The disadvantage was that commodities were perishable, bulky and difficult to move. A significant change was the transition from commodity bartering to the development of coinage as a common form of exchange. Metallic pieces were more durable and not depreciable.<sup>19</sup> The reliability of the coinage as a medium of exchange was due to both the formal authoritative endorsement of the coinage as a legal tender and the fact that the coinage itself retained an inherent intrinsic value based on market valuation.<sup>20</sup> In the Middle Ages, the State conferred a nominal value on coin rather than certifying the value of the coin, as had been the case in earlier periods.<sup>21</sup> It has been pointed out that the shift to nominal value did not of itself give rise to the development of paper money.<sup>22</sup> Nevertheless, nominalism weakened any suggestion that money was a commodity in the same way as cattle. In losing its intrinsic value, it became only a matter of time before paper could be endorsed as having substantive value by the State. The development of paper money arose in response to the growing sophistication of medieval mercantile fairs<sup>23</sup> and also as a

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<sup>14</sup> Benjamin Geva, 'From Commodity to Currency in Ancient History - On Commerce, Tyranny and the Modern Law of Money' [1987] 25 *Osgoode Hall Law Journal* 115, 125.

<sup>15</sup> PD Finn, above n 12.

<sup>16</sup> JM Sinclair (General Consultant), *Collins English Dictionary, Australian Edition*, (3<sup>rd</sup> ed, 1991), 489.

<sup>17</sup> Geva, above n 14, 121.

<sup>18</sup> See the definition of 'fungible' in JA Simpson and ESC Weiner, *The Oxford English Dictionary* (2<sup>nd</sup> ed, 1989) vol VI, 269; *United States Uniform Commercial Code*, Section 1-201 (17) in Pike and Fischer Inc (eds), *Uniform Commercial Code Reporting Service* (1965-) [¶ 1201]; American Law Institute, *Restatement of the Law of Restitution* (1937)§ 66 (4).

<sup>19</sup> Geva, above n 14, 129.

<sup>20</sup> *Ibid* 142-143. As to the State theory of money see Mann, above n 10, 14-22; Arthur Nussbaum, *Money in the Law National and International* (1950) 5-10.

<sup>21</sup> *Ibid* 142-143; Nussbaum, above n 20, 17-19.

<sup>22</sup> Geva, above n 14, 144.

precaution against thieves.<sup>24</sup> However, it was not until after the creation of the Bank of England in 1694 and the issue of bank notes by that institution,<sup>25</sup> that paper money became a widespread phenomenon and an essential form of cash.<sup>26</sup> Bank notes were, and are, far removed from the commodities of ancient times. As Lord Mansfield stated in *Miller v Race*:<sup>27</sup>

Now they are not goods, not securities, nor documents for debts, nor are so esteemed: but are treated as money, as cash, in the ordinary course and transaction of business, by the general consent of mankind; which gives them the credit and currency of money, to all intents and purposes. They are as much money, as guineas themselves; or any other current coin, that is used in common payments, as money or cash.<sup>28</sup>

Nevertheless, bank notes and coins retain a physical form and can be handled, preserved and destroyed like all physical objects. Henderson has labelled this system as a cash based system because these 'instruments of payment are treated as valuables.'<sup>29</sup> Coinage and notes 'store and convey value.'<sup>30</sup> In addition, the paper still functions as money in cases which are not regarded as legal tender. Treasury bills, bills of exchange and cheques would fall for consideration under this category. Henderson has described this paper based system as one which uses 'physical objects as evidence of a claim to value.'<sup>31</sup>

In the past, our legal system has adapted to the new forms of money and monetary transactions. It has been commented:

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<sup>23</sup> See John Chown, *A History of Money: From AD 800* (1994) Chapter 14.

<sup>24</sup> MJL Rajanayagam, *The Law Relating to Negotiable Instruments in Australia* (1980) [1.5].

<sup>25</sup> James Milne Holden, *The History of Negotiable Instruments in English Law* (1955) 87-94.

<sup>26</sup> For a general overview of paper money see Nussbaum, above n 20, 72-93.

<sup>27</sup> (1758) 1 Burr 452; 97 ER 398.

<sup>28</sup> Ibid 457; 401.

<sup>29</sup> Paul B Henderson Jr, 'Modern Money', in Elinor Harris Solomon (ed), *Electronic Funds Transfers and Payments: The Public Policy Issues* (1987) 19.

<sup>30</sup> Ibid.

<sup>31</sup> Ibid.

Lord Mansfield and his colleagues in the late eighteenth century were faced with radically new problems for which they devised radically new solutions.

The radically new problems all stemmed from the industrial revolution and the vastly increased number of commercial transactions which it spawned. When goods were shipped, they had to be paid for. The idea that the payments could be made in metallic currency, chronically in short supply, was ludicrous. The primitive banking system could not cope with the situation: the bank check which - a hundred years later - became the universal payment device was unknown. In effect the merchants and the bankers invented their own paper currency.<sup>32</sup>

Whilst the law merchant was the source of the law on commercial paper and was integrated into the common law,<sup>33</sup> Lord Mansfield decided two major cases which ensured that negotiable instruments were accepted as substitutes for metallic currency.<sup>34</sup> In so doing, Lord Mansfield (and his colleagues) not only assumed that the new way of dealing with payments was beneficial to commerce but he was also forced to adapt the legal rules to commercial realities.<sup>35</sup> Today courts face the same dilemma - adapting legal rules to take into account new commercial and technological practices.

### ***B Paperless Money***

At present, we are seeing the evolution and expansion of paperless money. Technology may have intruded to the extent that in the future there will be no need for coinage or notes at all.<sup>36</sup> At this point, it is necessary to distinguish paperless money from transactions which give rise to a paperless asset. For example, consider a savings account with a bank. Whilst the initial deposit and subsequent withdrawal is generally in the form of cash or paper manifestations of money (such as the banker's draft or the cheque), the debt itself which is recorded in the passbook is

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<sup>32</sup> Grant Gilmore, 'Formalism and the Law of Negotiable Instruments' (1979) 13 *Creighton Law Review* 441, 446-447.

<sup>33</sup> William H Lawrence, *Commercial Paper and Check Collection* (1990) §1.3.

<sup>34</sup> *Miller v Race* (1758) 1 Burr 452; 97 ER 398 and *Peacock v Rhodes* (1781) 2 Dougl. 633; 99 ER 402 which are discussed in Robert L Jordan and William D Warren, *Commercial Paper* (1983) 8-10.

<sup>35</sup> Gilmore, above n 32, 448-450.

<sup>36</sup> Steven Levy, 'The End of Money?' *Newsweek*, 7 November, 1995, 84; Henderson, above n 29, 19.

itself paperless. From an economic perspective, the bank account is a paperless asset which functions as money.<sup>37</sup>

However, from a legal perspective, the bank account is a legal chose in action. It is a right to bring an action to recover the debt.<sup>38</sup> If the customer brings an action for the recovery of the debt, he may receive cash from the bank in satisfaction of the debt. However, a debtor, such as the bank, may decide not to pay a creditor with cash. The debtor may have the facility to transfer funds electronically to the customer. Such a transaction is paperless and cashless. But, it is still intricately concerned with money and its receipt and transfer. In multiple transactions, the new electronic money can be constantly on the move. It can be in continual process of creation and destruction, for time periods so short that the “phantom money” can escape detection altogether.<sup>39</sup>

### *C Transactional Ephemerality*

As a consequence, there are two characteristics of the electronic based system which distinguish it from the earlier systems. First, the money (or value traded) is formless prior to, during and after the transfer process. There are no physical objects to convey value (other than the computer system) and it is not necessary (for the technology to work) for physical documents to evidence that claim for value.

Secondly, the process of transfer and storage of the data recording the transfer is electronically based. Whilst the transaction may also be recorded on paper, the paper representation is a copy of the primary transactional record which is electronically based. These two factors contribute to what will be referred to in the thesis as the transactional ephemerality of money. The ‘value’ credited to an individual in this system is neither discernible via a physical transaction nor necessarily long-lasting in the light of the speed of electronic transactions.<sup>40</sup>

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<sup>37</sup> Mann, above n 10, 5.

<sup>38</sup> See Henry Campbell Black, *Black's Law Dictionary* (6<sup>th</sup> ed, 1990) 241; John S James, *Stroud's Judicial Dictionary* (5<sup>th</sup> ed, 1986) vol 1, 428-430.

<sup>39</sup> Elinor Harris Solomon, ‘Money, Now and Future’ in Elinor Harris Solomon (ed), *Electronic Funds Transfers and Payments: The Public Policy Issues* (1987) 13.

<sup>40</sup> See *Mutual Pools & Staff Pty Ltd v The Commonwealth of Australia* [1993-1994] 179 CLR 155, 192-202 (Dawson and Toohey JJ); Chin Yen Lee, ‘Legal Implications of Technology in Banking’ (1988) 16 *Australian Business Law Review* 114, 117-118.

The phenomenon of transactional ephemerality is already part of everyday commercial dealings. Credit (or charge) cards, automatic teller machines (ATMS) and electronic funds transfer at point of sale (EFTPOS) sit in juxtaposition with cash based consumer transactions.<sup>41</sup> Linked to the development of electronic based banking and financial services between the consumer and the service provider, transfer systems between banks have also been created, notably in the Australian context, the Bank Interchange and Transfer System (BITS).<sup>42</sup>

In the light of the dramatic transformation of money from a barter based commodity to an electronically based one, it is imperative to ask why such changes have been possible or necessary. Some practical answers can be found in history. For example, from the seventeenth century onwards, merchants needed to develop new forms of negotiable instruments such as the bill of exchange and cheques in order to facilitate trade throughout distant parts of the world.<sup>43</sup> Other answers can be found in scientific and technological developments which have provided the opportunity to streamline the transfer and receipt of money.<sup>44</sup> Business has embraced electronic based systems for efficiency and competitiveness. These sorts of factors explain why money and transactions with money change form. However, they do not explain why items so disparate as commodities, coins, paper and electronic impulses have been used as money.

### **D Fungibility**

The answer lies in both a matter of fact and an issue of law. As a matter of fact, money is fungible whether as a coin or an electronic impulse. It is a thing (or now simply a value) which can be substituted for itself. One bag of wheat of a certain kind or quantity can be substituted for another bag of wheat of a similar kind or quality. One ten dollar note is as good as another in the discharge of a debt. An

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<sup>41</sup> For a discussion of such forms of electronic transfers see GA Weaver and CR Craigie, *The Law Relating to Banker and Customer in Australia* (2<sup>nd</sup> ed, 1990) [3.490]-[3.570]; Patrick Frazer, *Plastic and Electronic Money: New Payment Systems and Implications* (1985); Patrick RA Kirkman, *Electronic Funds Transfer Systems: The Revolution in Cashless Banking and Payments Methods* (1987); Mark Sneddon, 'Cyberbanking and Payment Products: Legal and Regulatory Issues' in *Banking Law and Practice, 14<sup>th</sup> Annual Conference* (1997) 167.

<sup>42</sup> Weaver, and Craigie, above n 41, [3.360].

<sup>43</sup> WR Cornish and G de N Clark, *Law and Society in England 1750-1950* (1989) 198-199. See generally, Holden, above n 25.

<sup>44</sup> See for example Levy, above n 36, 84.

electronic impulse which transfers \$100 is as good as another electronic impulse which transfers \$100. This notion of fungibility of money is very important because it underlies our concept of debt.<sup>45</sup> When customer A deposits money in Bank B, B is a debtor to A.<sup>46</sup> However, B is not expected by A to repay precisely the same notes and coinage deposited with B. The debt is satisfied if B repays A with an equivalent amount. The fungibility of money is an important source of its utility.

However, from a legal perspective, proprietary claims for money can be extremely difficult. There are generally no characteristics or earmarks which identify it so as to entitle a creditor to claim that he retains proprietary interest in certain money.

### ***E Negotiability***

As a matter of law, money is negotiable. Money is legally transferable in title by physical transfer from one party to another.<sup>47</sup> In *Miller v Race*,<sup>48</sup> a Bank of England note had been stolen and then passed into circulation. The plaintiff had obtained the note 'for full and valuable consideration, and in the usual course... of... business.'<sup>49</sup> The plaintiff successfully sued for payment on the note. Lord Mansfield commented:

It has been quaintly said, 'that the reason why money can not be followed is, because it has no ear-mark:' but that is not true. The true reason is, upon account of currency of it, it can not be recovered after it has passed into currency. So, in case of money stolen, the true owner can not recover it, after it has been paid away fairly and honestly upon a valuable and bonâ fide consideration: but before money has passed into currency, action may be brought for the money itself.<sup>50</sup>

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<sup>45</sup> For a legal definition of debt see James, above n 38, vol 2; 636-640; Black, above n 38, 403; LB Curzon, *Dictionary of Law* (4<sup>th</sup> ed, 1993) 106; Elizabeth A Martin (ed), *A Dictionary of Law* (3<sup>rd</sup> ed, 1994) 113; CRB Dunlop, *Creditor-Debtor Law in Canada* (1981) 15-20.

<sup>46</sup> *Pott v Clegg* (1847) 16 M & W 321, 328; 153 ER 1212, 1215 (Pollock CB); *Foley v Hill* (1848) 2 HLC 28, 36-37; 9 ER 1002, 1005-1006 (Lord Lyndhurst LC).

<sup>47</sup> *Moss v Hancock* [1899] 2 QB 111, 115-116 (Darling J).

<sup>48</sup> *Miller v Race* (1758) 1 Burr 452; 97 ER 398.

<sup>49</sup> *Ibid* 453; 398.

<sup>50</sup> *Ibid* 457-458; 401. See also *Peacock v Rhodes* (1781) 2 Doug 633; 99 ER 402.

Some one hundred and fifty years later, Lord Haldane made a similar comment in *Sinclair v Brougham*.<sup>51</sup> The negotiability of money underlies the operation of most business transactions<sup>52</sup> and gives money its peculiar but essential legal utility.<sup>53</sup> Therefore, as will be noted below,<sup>54</sup> even in ancient times money has been treated differently than other fungible items.

Factors which have been seen as generally re-inforcing the commercial norms in relation to the negotiability of money have been the capacity of a party to use funds for his own purposes<sup>55</sup> and payment of interest on the use of the funds.<sup>56</sup>

### ***F Denial of Fungibility and Negotiability***

Despite the fact that money is a negotiable commodity, it can retain characteristics in keeping with its chattel origins.<sup>57</sup> Our legal system has recognised that it is possible for money to be treated primarily as a chattel. In *Moss v Hancock*<sup>58</sup> a special minted gold coin was stolen and the Court held that the owner was entitled to an order for restitution of it. It was held that the coin had not been in currency at the time (despite the fact that the coin had been made currency of the realm by Royal Proclamation).<sup>59</sup>

The outcome of the case was indicative of an important process which, continues to be relevant today – namely, the need to deny the fungibility and negotiability of money before it can be accorded the status of a specific chattel for the purposes of proprietary relief.

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<sup>51</sup> [1914] AC 398, 418.

<sup>52</sup> Ibid; Phanor J Eder, 'Legal Theories of Money' (1934-1935) 20 *Cornell Law Quarterly* 53, 55-56.

<sup>53</sup> See MJL Rajanayagam, *The Law Relating to Negotiable Instruments in Australia* (1980) [1.2]-[1.4].

<sup>54</sup> Chapter 2, 67-68.

<sup>55</sup> American Law Institute, *The Restatement of the Law of Trusts 2nd* (1959) §12. See for example, *Bank of Nova Scotia v Société General (Canada)* (1988) 58 Alta LR (2d) 193.

<sup>56</sup> Ibid.

<sup>57</sup> Mann, above n 10, 8.

<sup>58</sup> [1899] 2 QB 111.

<sup>59</sup> Ibid, 117 (Darling J); 119-120 (Channell J).

The facts of *Moss v Hancock* were relatively straightforward. The coin was specially minted and had characteristics which made it possible to distinguish it. However, it has also been possible to reify money without any particular distinguishing characteristics into a specific chattel by the process of segregation.<sup>60</sup> The effect of such segregation has been to create a specific asset which could be subject to tortious actions of detinue or conversion<sup>61</sup> and the subject matter of a trust.<sup>62</sup> Therefore, in the light of the money as a specific asset, it is possible for a party to claim a proprietary interest in the money by virtue of its identifiability and non-negotiability. However, this assumes that the money is a physical asset capable of segregation.

### ***G The Law and the Changing Nature of Money***

The issue, in the light of the modern paperless money, is whether proprietary interests or proprietary relief can be claimed in what is essentially an incorporeal asset, (particularly when transactional ephemerality is born in mind). After all, in *Moss v Hancock*, it was the physical characteristic of the coin which preserved its chattel status. In paperless and incorporeal transactions, it would not appear to be possible to preserve its chattel status due to its non-physicality.

In the context of this transformation, steps have been taken to define the rights and liabilities of parties to transactions in a wide variety of electronic transactions which involve the transfer and receipt of money.<sup>63</sup> However, the general law remains an important source of the characterisation of monetary transactions and claims for proprietary interests in electronic money.<sup>64</sup>

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<sup>60</sup> Chapter 3, 102-106. For example *Carreras Rothmans Ltd v Freeman Matthews Treasure Ltd* [1985] Ch 207; *Cohen v Cohen* (1929) 42 CLR 91.

<sup>61</sup> J G Fleming, *The Law of Torts* (9<sup>th</sup> ed, 1998) 60-61 and fn 28.

<sup>62</sup> Worthington, above n 3, 61-66.

<sup>63</sup> For a discussion of the law in relation to electronic transfer of funds in the banking context see generally Anu Arora, *Electronic Banking and the Law* (2<sup>nd</sup> ed, 1993) Chapters 8 and 9; Chris Reed, *Electronic Finance Law* (1991); WS Weerasooria, *Banking Law and the Financial System in Australia* (4<sup>th</sup> ed, 1996) Chapters 8, 17, 18, 24 and 25; Henry Batel and Gavin Arbuckle, *Electronic Banking in Canada and the United States* (1987).

<sup>64</sup> See for example, Weaver, and Craigie, above n 41, Chapter 14; Arora above n 63.



Just as Lord Mansfield and his contemporaries were called upon to respond and provide practical and workable legal rules to take into account the changed nature of money and commercial transactions, so too, legislatures and the judiciary are being challenged to redefine legal norms where proprietary interests are claimed. So far, it appears that the response has been either a denial that legal rules can accommodate money in its metamorphosed electronic form<sup>65</sup> or a tenacious insistence on a proprietary base (with an apparent relaxation of rules as to how the specific proprietary base is ascertained).<sup>66</sup> Both responses are artificial. One of the major functions of this thesis is to propose an alternative approach to proprietary claims in relation to money.

#### IV COMMERCIAL TRANSACTIONS AND RISK

The third contextual component of the thesis is that the transactions which will be under investigation are essentially commercial transactions rather than personal or domestic ones. This may appear a trite assertion. However, it is important to emphasise the commercial nature of the transactions in order to understand the values which inform commercial activity and legal responses to that activity.

Such words as commerce and commercial are defined by reference inter alia to 'trade', 'buying and selling',<sup>67</sup> and 'matter of business looking toward financial profit.'<sup>68</sup> Commerce is concerned with the buying and selling of goods and services or the making of profit in a capitalist economy.

The feature which is common to all commercial transactions is the taking or assumption of risk of potential loss due to the nature of the transaction or the environment in which the transaction takes place.<sup>69</sup>

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<sup>65</sup> See for example Millett J in relation to common law tracing in *Agip (Africa) Ltd v Jackson* [1990] 1 Ch 265, 285-286.

<sup>66</sup> See for example, *Lipkin Gorman (A Firm) v Karpnale Ltd* [1991] 2 AC 548.

<sup>67</sup> Simpson and Weiner, above n 18, vol 3, 552

<sup>68</sup> *Ibid*, 553.

<sup>69</sup> For theoretical and historical perspectives on risk see Peter G Moore, *The Business of Risk* (1983), particularly Chapters 1-3; Peter L Bernstein, *Against the Gods: The Remarkable Story of Risk* (1996); Baruch Fischhoff, *et al*, *Acceptable Risk* (1981).

‘Risk’ is defined in *The Oxford English Dictionary* as:

To hazard, endanger, to expose to the chance of injury or loss

and

To venture upon, take the chances of<sup>70</sup>

‘Risky’ has been defined as:

Dangerous, hazardous, fraught with risk.<sup>71</sup>

Sometimes, the evaluation of risk and its consequences is based on perceptions of risk rather than the reality of risk.<sup>72</sup>

The kinds of risks to which a commercial party may be exposed are many and in some areas of the law, such risks are specifically dealt with as risks.<sup>73</sup> He is exposed to the possibility that the other party will breach its undertaking to perform certain tasks, that the subject matter of the contract is stolen or destroyed, that the goods which he produces are not as popular as he expects and do not sell on the market and that a more efficient competitor on the market takes his market share. One important risk which a commercial party may assume is the possibility that the party with whom he is dealing may become insolvent in the future. If the party is unsecured, then he assumes the risk that upon insolvency he may not be paid fully for the amount owing to him. Generally, these kinds of risks are viewed as part of the hurly-burly of commercial life. In the context of this thesis the question is - to what extent should a commercial party be expected to bear the risks associated with that status without any legal intervention?

There appear to be two major legal responses for dealing with the risks generally associated with commercial transactions. Today, these responses sit side by

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<sup>70</sup> Simpson and Weiner, above n 18, vol 13, 988.

<sup>71</sup> Ibid. See also F Wharton, ‘Risk Management: Basic Concepts and General Principles’ in Jake Ansell and Frank Wharton (eds), *Risk: Analysis, Assessment and Management* (1992) 1, 4.

<sup>72</sup> Wharton, above n 71, 5.

<sup>73</sup> See in relation to the sale of goods GHL Fridman, *Sale of Goods in Canada* (3<sup>rd</sup> ed, 1986), Chapter 13; LS Sealy ‘Risk’ in the Law of Sale’ [1972B] 31 *The Cambridge Law Journal* 225, 226-227; MG Bridge, *The Sale of Goods* (1997) 111-131; Darren Fitzgerald, ‘The Risk Issue in Sale’ (1996) 9 *Journal of Contract Law* 206.

side, if somewhat uneasily. However, both responses have fashioned our legal system, and in particular, the way that commercial parties react to commercial risk.

### ***A The Laissez-Faire Model of Commerce, Risk and Law***

First, there is the laissez faire model. Under this model, the individual who enters into the commercial world is required to ascertain his interests, take necessary action to protect those interests and control commercial risk. This basic model dealing with risk appears to have reached its zenith in 19th century England in the concept of caveat emptor.<sup>74</sup>

If the onus is on the individual person or enterprise to deal with the problem of commercial risk, then commercial players take the opportunity to ascertain the possible commercial risks and offset or, at the very least, minimise the risk which is perceived to exist. There are many responses to dealing with the minimisation of risk in commercial situations<sup>75</sup> including commercial research before entering into the transaction,<sup>76</sup> taking out insurance in respect to the perceived risk,<sup>77</sup> requiring and taking security from the other party and obtaining the guarantee of the potential loss from third parties.<sup>78</sup> In order to ensure that such self-protective mechanisms are efficient, it has been necessary to develop a highly effective legal environment to legitimise risk minimisation devices.

During the legally creative period of the 19th century, commercial parties demanded greater legal certainty, a greater array of risk minimisation devices and a more efficient judicial administration. In response to such demands, there were dramatic changes in both substantial and adjectival law. In response to the industrial revolution and a market based economy, the concept of contract was redefined in terms of the will theory of the individual. Not only could individuals freely negotiate the value of the contractual bargain, but they were required to protect their own

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<sup>74</sup> PS Atiyah, *The Rise and Fall of Freedom of Contract* (1979) 464.

<sup>75</sup> See for example, Edmund AC Crouch and Richard Wilson, *Risk/Benefit Analysis* (1982); Lester B Lave, *Risk Assessment and Management* (1987).

<sup>76</sup> For a helpful cojoining of economic concerns and legal responses see Charles O Hardy, *Readings in Risk and Risk-Bearing* (1924) 7-12.

<sup>77</sup> Ibid Chapters XIII, XIV and XV.

<sup>78</sup> Ibid Chapter XVI.

interests. Courts would intervene to set aside a transaction only in such exceptional situations as fraud or actual undue influence.<sup>79</sup> The emphasis on the intention of the parties and the sanctity of contract led to the growth of legal formalism.<sup>80</sup>

There was a great interest in the systematisation of the substantive law by virtue of legislative codification. Parliament began to standardise, in legislative form, the ways that commercial operators dealt with one another and the legal relationship, rights and obligations assumed by the parties. The three tools which were utilised to protect interests and to manage the commercial risk were schemes which regulated how commercial relationships operated,<sup>81</sup> schemes of registration of ownership or security interests<sup>82</sup> and statutory rules concerning the passing of title in contracts for the sale of goods and the imposition of security interests.<sup>83</sup> Statutory codification was interpreted as positivist in nature<sup>84</sup> so that legislation was seen as authoritative and clearly intentional commands.<sup>85</sup> These trends enhanced the means by which a creditor could obtain a secured status and minimise loss in the event of insolvency of the debtor.

Risk minimisation devices were developed and consolidated. Commercial parties used the limited liability company and the veil of incorporation to protect the

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<sup>79</sup> Examples of cases where transactions were set aside see *Earl of Aylesford v Morris* (1873) 8 Ch App 484 and *Allcard v Skinner* (1887) 36 Ch D 145.

<sup>80</sup> Atiyah, above n 74, 389.

<sup>81</sup> For example, sale of goods - *Sale of Goods Act* 1893 (UK); bills of sale - *Bills of Sale Act* 1878 UK; partnership - *Partnership Act* 1890 UK; pawnbroking - *Pawnbrokers Act* 1872 (UK).

<sup>82</sup> For example *Real Property Act* 1858 (SA). See P Moerlin Fox, 'The Story Behind the Torrens System' (1950) 23 *The Australian Law Journal* 489; DJ Whalan, 'The Origins of the Torrens System and its Introduction into New Zealand' in GW Hinde (ed), *The New Zealand Torrens System Centennial Essays* (1971) 1; MA Neave, CJ Rossiter and MA Stone, *Sackville and Neave: Property Law Cases and Materials* (5<sup>th</sup> ed, 1994) [7.31]-[7.33]; Adrian J Bradbrook, Susan V MacCallum and Anthony P Moore, *Australian Real Property Law* (2<sup>nd</sup> ed, 1997) [4.01]-[4.08].

<sup>83</sup> *Sale of Goods Act* 1979 (UK) ss 16-25 and ss 41-45. See also PS Atiyah and John Adams, *The Sale of Goods* (9<sup>th</sup> ed, 1995) Chapters 17, 18 and 23; Fridman, above n 73, Chapters 4, 5 and 14; KCT Sutton, *Sales and Consumer Law in Australia and New Zealand*, (4<sup>th</sup> ed) Part III and Chapter 21; Atiyah, above n 74, 102, 255.

<sup>84</sup> Atiyah, above n 74, 102, 255; *The Governor and the Company of the Bank of England v Vaughan Brothers* [1891] AC 107, 120 (Lord Halsbury).

<sup>85</sup> *Ibid.*

assets from creditors.<sup>86</sup> Whilst insurance was not an invention of the 19th century,<sup>87</sup> there was a consolidation and expansion of insurance practices.<sup>88</sup>

Security devices expanded in scope. There was a re-appropriation and utilisation of security devices in the 18th and 19th Centuries which had been current during Roman times. The kinds of consensual security devices (as distinct from imposed security devices) which had Roman roots were the *hypotheca* or charge and the pledge.<sup>89</sup> New or modified forms of security developed such as hire purchase and bills of sale.<sup>90</sup> These devices were used to elevate the otherwise unsecured creditor to a secured status.

Commercial operators, governments and lawyers became increasingly concerned that the risk minimisation devices were certain and easily enforceable. The successful operation of 19th century individualism depended upon a clear, certain and predictable legal system. If the individual commercial participant was responsible for protecting his interests, then the commercial operator was entitled to rely on the certainty and validity of the transaction. If the individual could not access risk management techniques which were supported by a well organised and predictable legal system, then the underlying notion of individual responsibility broke down in practical terms. And, if the individual could not take foolproof methods to protect his interests as part of the risk management strategy, then, the underlying concept of self-reliant individualism would begin to break down. Therefore, it is not surprising that politicians, men of commerce and lawyers began to take a critical interest in the functioning of the legal system. This resulted in the practical re-organisation of the court system and procedural rules of law culminating in the *Judicature Act 1873* (UK).

In addition to administrative re-organisation, there were judicial pronouncements extolling the virtues of certainty of the law and the limited function of the courts. The responsible judicial creativity which Lord Mansfield personified,

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<sup>86</sup> For an excellent short account of the origins and development of the limited liability company see Cornish and Clark, above n 43, 246-262; Paul L Davies, *Gower's Principles of Modern Company Law*, (6<sup>th</sup> ed, 1997) Chapters 1-3 and particularly 40-48.

<sup>87</sup> AA Tarr, Kwai-Lian Liew and W Holligan, *Australian Insurance Law* (2<sup>nd</sup> ed, 1991) 1-4.

<sup>88</sup> Cornish and Clark, above n 43, 512-515.

<sup>89</sup> WW Buckland, *Equity in Roman Law* (1911) 63-71.

<sup>90</sup> Cornish and Clark, above n 43, 237-246.

was stifled in the 19th century. The practice of following precedents (evolved from an 18th century doctrine of *stare decisis*) hardened into a set of rules.<sup>91</sup> Generally speaking, the courts had abandoned the idea that the courts could and did make the law.

Consistent with the restrictive attitude towards judicial intervention in contractual relationships and the strict hierarchy and limitations imposed by the law of precedent, equitable jurisdiction was considerably curtailed.<sup>92</sup> Nevertheless, equitable jurisdiction was creatively used in some ways. The issue of equitable jurisdiction will be further considered later in this chapter.

### **1 Weaknesses of the Laissez-Faire Model**

The strength of the laissez-faire model as a response to commercial risk was (and is) that it does allow the commercial parties a considerable amount of freedom to negotiate the kinds of risk minimisation methods which can be used. However, it can be an inflexible and insensitive tool because it is presupposed that individuals control and pre-empt events.

First, it assumes that economic conditions are completely predictable and that parties to commercial relationships should anticipate all contingencies. Whilst commercial parties should anticipate, as much as possible, economic downturns, sudden loss of supply of goods or services, sudden falls in the value of currency or force majeure, there will always be situations which are beyond a contracting party's contemplation.<sup>93</sup>

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<sup>91</sup> Jim Evans, 'Change in the Doctrine of Precedent during the Nineteenth Century' in Laurence Goldstein (ed), *Precedent in Law* (1987) 35, 64-72. See also *The London Street Tramways Co Ltd v The London County Council* [1898] AC 375, 380 (Earl of Halsbury LC); *Beamish v Beamish* (1861) 9 HL Cas 273; 11 ER 735.

<sup>92</sup> Atiyah, above n 74, 392-393, 671-680.

<sup>93</sup> See for example, *Prager v Blatspeil, Stamp and Heacock Ltd* [1924] 1 KB 566 and *SP Co v F Co* Reichsgericht, Third Civil Senate, 21 September, 1920, 100 ERG (Z) 129 extracted in Arthur Taylor von Mehren, *The Civil Law System* (1957) 733-737.

Secondly, literally and inflexibly applied, the laissez-faire model would not provide remedial relief for innocent and unintended errors such as factual and legal mistakes<sup>94</sup> or ultra vires transactions.<sup>95</sup>

Thirdly, the model assumes that parties have the time, resources and inclination to laboriously set out all their rights and liabilities in contracts and to take steps to minimise risk.

The pace of economic activity and the immense technological changes in business transactions in the 20th century have meant that there will be occasions where there is no supporting documentation or the supporting documentation is inadequate, because it is impossible to address all the potential problems which may arise. It may be economically inefficient to spend the time and money in the light of the relatively small size of the transaction. Alternatively (but not inconsistently), the situation may be so urgent that the parties do not have time to conclude a contract or obtain securities.<sup>96</sup> In ground-breaking research, Macaulay<sup>97</sup> published the results of interviews with business people and lawyers which showed that in fact, there was often little legal planning. The focus was on commercial matters rather than legal niceties. In a later article he demonstrated that in the 'battle of the forms'<sup>98</sup> boilerplate terms were sometimes incomprehensible and inconsistent. In one case, a manufacturer had failed to set up a valid and binding contract with customers up to 75% of the time.<sup>99</sup>

Fourthly, where there is written documentation, it cannot be assumed that the contract is the product of the fully informed intention and will of the parties. Sometimes a party is placed under an inordinate pressure to enter a commercial

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<sup>94</sup> *David Securities Pty Ltd v Commonwealth Bank of Australia* (1992) 175 CLR 353; *Rover International Ltd v Cannon Film Sales Ltd* [1989] 1 WLR 912; *Barclays Bank Ltd v WJ Simms Son and Cooke (Southern) Ltd* [1980] 1 QB 677.

<sup>95</sup> For example, *Hazell v Hammersmith and Fulham London Borough Council* [1992] 2 AC 1.

<sup>96</sup> See for example *Prager v Blatspiel, Stamp and Heacock Ltd* [1924] 1 KB 566; *China Pacific SA v Food Corporation of India* ('The Winson') [1982] AC 939.

<sup>97</sup> Stewart Macaulay, 'Non-Contractual Relations in Business: A Preliminary Study' (1963) 28 *American Sociological Review* 55. Note also Stewart Macaulay, 'An Empirical View of Contract' [1985] *Wisconsin Law Review* 465.

<sup>98</sup> *Ibid* 59.

<sup>99</sup> *Ibid* 60.

transaction. On other occasions, there is the problem of bargaining power. In this context, there is a continuing debate over the impact of standard forms on contract law.<sup>100</sup> Slawson<sup>101</sup> has demonstrated that mutual intention and assent cannot be considered the basis of standard contracts. Consumers are presented with a standard form contract, as a 'fait accompli' and are expected to sign the contract without any or little negotiation.

Of course, it is arguable that in all the situations described here, the parties have assumed the risk of the absence of or inadequate legal documentation. This is an important argument against legislative and judicial intervention. However, this point of view can run very thin. In these situations, the laissez-faire model of commercial risk assumption is under strain because it cannot be assumed that the parties have, or would have, accepted the transaction as it transpired.

## ***2 The Laissez-Faire Model and Receipt and Transfers***

In the specific context of the kinds of transfers and receipts described, the laissez-faire approach to commercial transactions would severely curtail judicial intervention. It could be contended that the availability of a wide array of risk minimisation and security devices (in the framework of a legislative system dealing with bankruptcy) are sufficient measures to minimise and deflect risk. Therefore, the onus is on unsecured creditors to elevate their status to that of secured creditors or take other forms of risk minimisation. However, there may be a number of obstacles to effective risk minimisation or deflection including the nature of the transaction, the pace of economic activity and the bargaining power of the parties. The laissez-faire approach is inadequate to deal with those situations where it is for one party to take action to protect their interests in the event of the insolvency of the other. A more sophisticated and sensitive approach is needed.

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<sup>100</sup> See for example, Edward J Jacobs, 'The Battle of the Forms: Standard Term Contracts in Comparative Perspective' (1985) 34 *International and Comparative Law Quarterly* 297 and Ewan McKendrick, 'The Battle of the Forms and the Law of Restitution' (1988) *Oxford Journal of Legal Studies* 197.

<sup>101</sup> W David Slawson, 'The New Meaning of Contract: The Transformation of Contract Law by Standard Forms' (1984) 46 *University of Pittsburgh Law Review* 21, 24-28.



## ***B The Interventionist Model Response to Commercial Transactions and Risk***

In the light of the general weaknesses of the laissez-faire model, it is not surprising that there have been considerable reactions against it. The alternative model accepts and, indeed, supports the active intervention of both the legislature and judiciary for the purposes of re-appraising the commercial assumption of risk. This approach has ancient legal antecedents in the civil law and common law traditions. Despite the differences between the two systems,<sup>102</sup> it is clear that they have one common and essential thread which is entirely absent from the laissez-faire model. Notwithstanding the arms-length nature of the transaction, on some occasions the commercial interests or needs of one party will be accorded more weight than the other party's. In order to achieve this, the legislature and/or the judiciary impose certain minimum legal standards of how parties should operate and conduct their commercial affairs. All commercial transactions operate against the backdrop of those minimum standards. It is only upon conformity to these minimum standards that it can be said that both parties have assumed the commercial risks inherent in the transaction. The civil law tradition will not be discussed here, suffice to say that its approach to commercial transactions reaches back to Roman and medieval times and is encapsulated in the phrase - duty to act in good faith or bona fides.<sup>103</sup> The duty to act in good faith is alive and well in Europe<sup>104</sup> and even in the United States.<sup>105</sup>

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<sup>102</sup> Mary Ann Glendon, Michael Wallace Gordon and Christopher Osakwe, *Comparative Legal Traditions* (1994) 41. For an interesting discussion of some of the similarities between the two traditions see RH Helmholtz, 'Continental Law and Common Law: Historical Strangers or Companions?' [1990] *Duke Law Journal* 1207.

<sup>103</sup> Barry Nicholas, *An Introduction to Roman Law* (1962) 163-164, 171; FH Lawson, *A Common Lawyer Looks at the Civil Law* (1953) 124-125; Peter Stein, 'Equitable Principles in Roman Law' in Peter Stein (ed), *The Character and Influence of the Roman Civil Law* (1988) 19, 25-26; DH Van Zyl, *History and Principles of Roman Private Law* (1983) Chapter 24; Rudolph Sohm, *The Institutes: A Textbook of the History and System of Roman Private Law* (3<sup>rd</sup> ed, 1907), 102-103; OF Robinson, TD Fergus and WM Gordon, *European Legal History* (2<sup>nd</sup> ed, 1994) [6.6.8]-[6.6.9]; JF O'Connor, *Good Faith in English Law* (1990) 81-84.

<sup>104</sup> See generally O'Connor, above n 103, 85-98.

<sup>105</sup> HK Lücke, 'Good Faith and Contractual Performance' in PD Finn (ed), *Essays on Contract* (1987) 155, 155-156. See also *Kirke La Shelle Co v Paul Armstrong Co* 263 NY 79; 188 NE 163 (Court of Appeals New York, 1933); Steven J Burton, 'Breach of Contract and the Common Law Duty to Perform in Good Faith' (1980) 94 *Harvard Law Review* 369, 404. American Law Institute, *Restatement of the Law, Contracts*, 2<sup>nd</sup> (1981) vol 2 § 205 and Robert S Summers, 'General Duty of Good Faith - Its Recognition and Conceptualisation' (1982) 67 *Cornell Law Review* 810, 814.

In comparison to the civil law, the common law tradition (with which this thesis is concerned) has, arguably, provided a piecemeal, fragmented and incoherent judicial response to commercial risk. Part of the reason for this situation has been that 19th century politicians, lawyers and commercial operators were far from sanguine about legislative or judicial intervention in commercial transactions. However, notwithstanding this aversion to intervention, there have been some important and lasting judicial responses to the issue of risk assumption in commercial transactions. One prominent example was the method of implying terms in contracts. The courts rationalised the implication of terms in contracts on the basis of the inferred or presumed intention of the parties.<sup>106</sup> But, the implication of terms did reflect an adjustment away from laissez-faire individualism. The concept of implied terms remains part of the legislative landscape today.<sup>107</sup>

In order to construct a theory of how courts and insolvency administrators ought to respond to the commercial transactions described, it is necessary to highlight certain tools which have been utilised to explain and justify judicial intervention in commercial relationships. Three tools are important in this thesis.

## **1 Duty of Disclosure**

It is apparent that English common law did absorb notions of good faith from the civil law traditions where insurance contracts were under scrutiny.<sup>108</sup> Lord Mansfield held that good faith was:

The governing principle...applicable to all contracts and dealings. Good faith forbids either party by concealing what he privately knows, to draw the other into a bargain, from his ignorance of that fact, and his believing the contrary.<sup>109</sup>

Lord Mansfield's statement was made in the context of the law governing insurance contracts. An insurance contract was (and remains) a contract of *uberrima fides*. The insured was required to disclose accurately all the material facts which were

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<sup>106</sup> *The Moorcock* 14 PD 64, 68 (Bowen LJ).

<sup>107</sup> For an informative discussion of implied terms see AG Guest, 'Implied Terms' in AG Guest (ed), *Chitty on Contracts* (27<sup>th</sup> ed, 1994), 901.

<sup>108</sup> Lücke, above n 105, 156-157.

<sup>109</sup> *Carter v Boehm* (1766) 3 Burr 1905, 1909-1910; 97 ER 1162, 1164.

necessary for the insurer to review before entering into the insurance contract. Lord Mansfield stated:

Insurance is a contract upon speculation.

The special facts, upon which the contingent chance is to be computed, lie most commonly in the knowledge of the insured only: the underwriter trusts to his representation, and proceeds upon confidence that he does not keep back any circumstance in his knowledge, to mislead the under-writer into a belief that the circumstance does not exist, and to induce him to estimate the risque as if it did not exist. The keeping back such a circumstance is a fraud and therefore the policy is void. Although the suppression should happen through mistake, without any fraudulent intention; yet still the under-writer is deceived, and the policy is void; because the risque run is really different from the risque understood and intended to be run, at the time of the agreement.<sup>110</sup>

In the 19th century, Lord Mansfield's endorsement of the duty of good faith was eclipsed by the perceived need to develop essentially predictable or even scientific legal method.<sup>111</sup> Notwithstanding the 19th century assault on the concept of good faith, the duty of disclosure remained an important aspect of insurance contract law. Its incorporation into insurance contracts was not totally antithetical to laissez-faire individualism in the sense that it enforced the view that the four corners of the contract regulated the relationship of the parties. However, it went against the concept of caveat emptor because it was recognised and accepted that an insurer or underwriter was not expected to know completely about the property or transaction which it insured. Whilst the duty of disclosure is mutual, it will rarely be required from the insurer or the underwriter.<sup>112</sup> The duty transferred the onus to disclose any irregularities on the insured and created a duty of disclosure in what was otherwise a straightforward arm's-length commercial transaction.<sup>113</sup>

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<sup>110</sup> Ibid.

<sup>111</sup> Lücke, above n 105, 157-158.

<sup>112</sup> Tarr, Liew and Holligan, above n 87, 70 and fn 2.

<sup>113</sup> For a comprehensive discussion of the duty of disclosure in insurance contracts see Semin Park, *The Duty of Disclosure in Insurance Contract Law* (1996). Shorter accounts can be found in Anthony Duggan, Michael Bryan and Frances Hanks, *Contractual Non-Disclosure* (1994) 71-83; ER Hardy Ivamy, *General Principles of Insurance Law* (6<sup>th</sup> ed, 1993), Chapters 12 and 13; Robert Merkin (ed), *Colinvaux's Law of Insurance* (6<sup>th</sup> ed, 1990) [5.01]-[5.10]. From a legislative perspective see of the *Insurance Contracts Act 1984* (Cth) Part II; *Marine Insurance Act 1906* (UK) s 18.

It will be contended that a duty of disclosure is no longer confined to insurance cases. A duty to disclose may apply to situations where a commercial party could not be expected to know or understand the nature and extent of the risk involved, particular the potential insolvency of the other party.

## 2 *Quasi-Contract*

Courts have had to intervene in situations where a party had refused to refund money to another where the money had been paid or services were rendered or goods supplied in a situation which was not regulated by a contract. There was no contract or the contract was ineffective. In the 18th and 19th centuries such intervention by courts was known as quasi-contract<sup>114</sup> and the respective actions were for money had and received, quantum meruit (recovery for services rendered) and quantum valebat (price for goods supplied).<sup>115</sup> The action for money had and received became extremely important prior to the 18th century. Two events ensured that this would be the case. In the seminal decision in *Slade's case*,<sup>116</sup> it was held that a promise to pay a debt could be implied from the facts of a case. The contract or promise was simply a fiction. The other fact was that the growth of the writ of *indebitatus assumpsit* superseded debt and account in the 16th century, so that quasi-contractual claims were enforced under that writ rather than the writs of debt or account.<sup>117</sup> Lord Mansfield said:

If the defendant be under an obligation, from the ties of natural justice, to refund; the law implies a debt, and gives this action, founded in the equity of the plaintiff's case, as it were upon a contract ('quasi ex contractu', as the Roman law expresses it).<sup>118</sup>

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<sup>114</sup> Lord Goff of Chieveley and Gareth Jones, *The Law of Restitution* (4<sup>th</sup> ed, 1993) 3-5

<sup>115</sup> *Ibid* 3-4.

<sup>116</sup> (1602) 4 Co Rep 92a; 76 ER 1072. For a discussion of the case see JH Baker, 'New Light on *Slade's Case*' (1971) 29 *The Cambridge Law Journal*, 51 and 213; David Ibbetson 'Sixteenth Century Contract Law: *Slade's Case* in Context' (1984) 4 *Oxford Journal of Legal Studies* 295.

<sup>117</sup> Goff and Jones, above n 114, 3-5, 6-9.

<sup>118</sup> *Moses v Macferlan* (1760) 2 Burr 1005, 1008; 97 ER 676, 678. Other cases where similar sentiments were expressed were *White v Copeland* (1894) 15 LR (NSW) 281, 288 (Darley CJ); *R v Brown* (1912) 14 CLR 17, 25 (Griffiths CJ); *Campbell v Kitchen & Sons Ltd and Brisbane Soap Company* (1910) 12 CLR 515, 531 (Barton J); *Sargood Brothers v The Commonwealth* (1910) 11 CLR 258, 303 (Isaacs J).

In the 19th century, some judges attempted to rationalise and legitimise the existence of quasi-contractual actions on the basis of an implied contract theory.<sup>119</sup> But the law of quasi-contract was derided by others.<sup>120</sup> Despite these mixed responses, the law of quasi-contract and its descendant (known as the law of restitution which incorporates the law of quasi-contract),<sup>121</sup> is an example where courts have intervened to adjust legal relations. Important substantive situations where courts intervened were payment under mistake<sup>122</sup> and payment under compulsion.<sup>123</sup> The law of restitution is discussed further below.

### 3 Equity

Equitable jurisdiction has been a central and substantial tool of judicial intervention in commercial relationships. The traditional use of equity in its proprietary mode will be considered in Chapter 2. The conventional basis upon which equity has intervened has been on the notion of ‘conscience’,<sup>124</sup> a principle which has ecclesiastical origins and which did not rest well with the harsher laissez-faire individualism of the 19th century. Despite the fact that there were concerns expressed about the intervention of equity in commercial transactions,<sup>125</sup> equity still prescribed certain minimal standards of conduct in some commercial situations.

Equity intervened to prevent equitable fraud, which is wider in scope than actual fraud. In the seminal case, *Earl of Chesterfield v Janssen*,<sup>126</sup> Lord Hardwicke

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<sup>119</sup> *Freeman v Jeffries* (1869) LR 4 Ex 189; *Re Rhodes* (1890) 44 Ch D 94, 105 (Cotton LJ); *Sinclair v Brougham* [1914] AC 398, 415 (Viscount Haldane LJ), 452 (Sumner LJ).

<sup>120</sup> *Baylis v Bishop of London* [1913] 1 Ch 127, 140 (Hamilton LJ); *Holt v Markham* [1923] 1 KB 504, 513 (Scrutton LJ).

<sup>121</sup> Goff and Jones, above n 114, 3-5.

<sup>122</sup> See for example *Norwich Union Fire Insurance Society Ltd v William H Price Ltd* [1934] AC 455; *Kerrison v Glyn, Mills, Currie & Co* (1911) LKKB 465 (HL); *Larner v London County Council* [1949] 2 KB 683.

<sup>123</sup> See for example in relation to the compulsory discharge of another’s liability *Moule v Garrett* (1872) LR 7 Ex 101; *Johnson v Royal Mail Steam Packet Co* (1867) LR 3 CP 38; and duress or improper pressure *Smith v William Charlick Ltd* (1924) 34 CLR 38.

<sup>124</sup> Patrick Parkinson, ‘The Conscience of Equity’ in Patrick Parkinson (ed), *The Principles of Equity*, (1996) 28, [201]-[202].

<sup>125</sup> *New Zealand & Australian Land Co v Watson* (1881) 7 QBD 374, 382 (Bramwell LJ). For a discussion of equity in the 19th century see Atiyah, above n 74, 388-393.

<sup>126</sup> (1751) 2 Ves Sen 125; 28 ER 82.

said that the Court of Chancery had jurisdiction to provide relief against all forms of fraud. They are still relevant today. He said:

1...fraud, which is *dolus malus*, may be actual, arising from facts and circumstances of imposition; which is the plainest case.

2. It may be apparent from the intrinsic nature and subject of the bargain itself; such as no man in his senses and not under delusion would make on the one hand, and as no honest and fair man would accept on the other; which are unequitable and unconscientious bargains...

A 3<sup>d</sup> kind of fraud is, which may be presumed from the circumstances and condition of the parties contracting; and this goes farther than the rule of law; which is, that it must be proved, not presumed; but it is wisely established in this court to prevent taking surreptitious advantage of the weakness or necessity of another: which knowingly to do is equally against the conscience as to take advantage of his ignorance: a person is equally unable to judge for himself in one as the other.

A 4<sup>th</sup> kind of fraud may be collected or inferred in the consideration of this court from the nature and circumstances of the transaction, as being an imposition and deceit on the other persons not parties to the fraudulent agreement.<sup>127</sup>

Lord Hardwicke envisaged the investigation of the circumstances leading up to a contract and the very nature of the contract itself. These notions of fraud were substantively articulated in equitable doctrines which set aside commercial transactions on the basis of undue influence,<sup>128</sup> relief against forfeiture<sup>129</sup> or estoppel.<sup>130</sup>

Equity also began to develop other doctrines during the 18th century and early 19th century to deal with the new demand of an industrialising England. It was at this time that the concept of the fiduciary obligation, derived from the trust, was

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<sup>127</sup> Ibid 155-156; 100.

<sup>128</sup> *Earl of Aylesford v Morris* (1873) LR 3 Ch App; *Allcard v Skinner* (1887) 36 Ch D 145.

<sup>129</sup> *Hill v Barclay* (1810) 16 Ves Jun 402; 33 ER 1037; (1811) 18 Ves 56; 34 ER 238; *Sanders v Pope* (1806) 12 Ves Jun; 33 ER 108.

<sup>130</sup> *Loffus v Maw* (1862) 3 Giff 592; 66 ER 544; *Burrowes v Lock* (1805) 10 Ves 470; 32 ER 927; *Hammersley v De Biel* (1845) 12 Cl & Fin 45; 8 ER 1312; PD Finn, 'Equitable Estoppel' in PD Finn (ed), *Essays in Equity* (1985) 59, 62-65.

given independent expression.<sup>131</sup> The doctrines of marshalling,<sup>132</sup> contribution,<sup>133</sup> subrogation<sup>134</sup> and equitable assignments<sup>135</sup> were developed and utilised with considerable effect in order to sustain the viability and integrity of commercial transactions. Equitable tracing developed in part as a response to the complexity of commercial transactions involving money.<sup>136</sup> These are considered in Chapter 2. The equitable action for breach of confidence also originated during the 19th century.<sup>137</sup>

Equity has also remained a significant supplement not only to the inadequacies and deficiencies of the common law, but also to legislation. Equity was engrafted on what were complex and sophisticated legislative property and security registration systems. These systems were an attempt to create certainty both for owners, security holders and potential creditors. In some security systems such as the Torrens system,<sup>138</sup> equity was employed as a necessary adjunct to the codified system in order for the scheme to work.<sup>139</sup>

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<sup>131</sup> LS Sealy, 'Fiduciary Relationships' [1962] *The Cambridge Law Journal* 69; LS Sealy, 'Some Principles of Fiduciary Obligation' [1963] *The Cambridge Law Journal* 119; Finn, above n 12, [2].

<sup>132</sup> See *Webb v Smith* (1885) 30 Ch D 192. For a discussion of the historical antecedents of the doctrine of marshalling see Sir William Holdsworth, *A History of English Law* (2<sup>nd</sup> ed, 1937) vol 6, 656-657.

<sup>133</sup> See *Dering v Earl of Winchelsea* (1787) 1 Cox 318; 29 ER 1184. For a discussion of the origins of the doctrine of contribution see *Albion Insurance Co Ltd v Government Insurance Office* (1969) 121 CLR 342.

<sup>134</sup> See *Randal v Cockran* (1748) 1 Ves Sen 98; 27 ER 916. For an discussion of the historical antecedents see RP Meagher, WMC Gummow and JRF Leane, *Equity Doctrines and Remedies* (3<sup>rd</sup> ed, 1992) [901].

<sup>135</sup> *Holroyd v Marshall* (1862) 10 HLC 191; 11 ER 999; *Tailby v Official Receiver* (1888) 13 App Cas 523; *Milroy v Lord* (1862) 4 De GF & J 264; 45 ER 1185.

<sup>136</sup> *Re Hallett's Estate; Knatchbull v Hallett* (1880) 13 Ch D 696.

<sup>137</sup> *Morison v Moat* (1851) 9 Hare 24; 68 ER 492.

<sup>138</sup> In relation to the Torrens system see *Barry v Heider* (1914) 19 CLR 197; Peter Butt, *Land Law* (3<sup>rd</sup> ed, 1996) [2021]-[2022]; Peter Butt and Frank Ticehurst, *Woodman and Nettle: The Torrens System in New South Wales* (1985) [74F], particularly [74F.20] and [74F.100].

<sup>139</sup> For a discussion of the relationship of the present *Sale of Goods Act* 1979 (UK) and equity see LS Sealy 'The Contract of Sale of Goods' in AG Guest (ed), *Benjamin's Sale of Goods* (4<sup>th</sup> ed, 1992) 3, [1-008]-[1-1010]. Note also DW Greig and JLR Davis, *The Law of Contract* (1987) 881.

#### 4 Equity in the 20th Century - Identification of Risk Assumption

The history of the equitable jurisdiction in the 19th century shows that there was an uneasy and often irreconcilable truce between laissez-faire individualism on the one hand and a secular commercial morality on the other. Twentieth century judges and legislatures inherited the ambiguities and incongruities associated with this uneasy truce. Equitable intervention is still viewed by some with scepticism. For example, Lord Browne-Wilkinson stated in *Westdeutsche Landesbank Girozentrale v Islington London Borough Council*:<sup>140</sup>

My Lords, wise judges have often warned against the wholesale importation into commercial law of equitable principles inconsistent with the certainty and speed which are essential requirements for the orderly conduct of business affairs...If the bank's arguments are correct, a businessman who has entered into transactions relating to or dependent upon property rights could find that assets which apparently belong to one person in fact belong to another; that there are 'off balance sheet' liabilities of which he cannot be aware; that these property rights and liabilities arise from circumstances unknown not only to himself but also to anyone else who has been involved in the transactions. A new area of unmanageable risk will be introduced into commercial dealings.<sup>141</sup>

Nonetheless, in the latter half of the 20th century, there has been a greater willingness on both courts and legislatures to intervene in commercial relationships - to an extent that 19th century lawyers would have abhorred.

Legislative intervention has been expansive and wide ranging in common law jurisdictions in order to ensure that commercial parties conform to certain minimum standards of conduct. Therefore, in Australia for example, legislation protects consumers,<sup>142</sup> regulates the provision of credit to consumers,<sup>143</sup> re-opens certain

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<sup>140</sup> [1996] AC 669.

<sup>141</sup> Ibid 704-705. See also *Henry v Hammond* [1913] 2 KB 515, 521 (Channell J); *Scandinavian Trading Tanker Co AB v Flota Petrola Ecuatoriana* [1983] 2 AC 694, 703-704 (Lord Diplock citing Lord Goff in the Court of Appeal decision below); *Austotel Pty Ltd v Franklins Selfserve Pty Ltd* (1989) 16 NSWLR, 582, 585-586 (Kirby P).

<sup>142</sup> *Trade Practices Act 1974* (Cth) Part V.

<sup>143</sup> For example, *Consumer Credit Act 1994* (NSW); *Consumer Credit Act 1994* (Qld). For a comprehensive review of the consumer credit legislation see Paul Sugden, 'Credit' in RB Vermeesch and Justice KE Lindgren, *Business Law of Australia* (9<sup>th</sup> ed, 1998) 1004.



kinds of contracts which are considered to be 'unjust',<sup>144</sup> and prohibits commercial conduct which is considered to be unconscionable.<sup>145</sup>

Courts have also taken a more interventionist approach to commercial transactions. Equity remains a major innovative tool of judicial intervention. As *Earl of Chesterfield v Janssen* showed,<sup>146</sup> equity has redefined the notion of conscience from ecclesiastical conscience to a secular conscience which identifies various kinds of unconscionable conduct.<sup>147</sup> The concept of unconscionable conduct continues to develop in response to modern conditions.

In particular, it will be contended that equity's secular concept of conscience has broadened sufficiently to deal with the kinds of situations which form the first contextual component of the thesis. The concept of unconscionable conduct is further considered in Chapter 5. These are commercial transactions where a party is presumed to have assumed the risks associated with his unsecured status in the event of the insolvency of the other party. As money is the subject of the commercial transaction, it is equally assumed that as money is negotiable, title to the money passes to the recipient and/or collector of that money. This thesis addresses those situations where the nature of the transaction and the relationship of the parties is such that it cannot be presumed that there was an assumption of that risk.

## V BANKRUPTCY AND INSOLVENCY

The fourth contextual component is the law of bankruptcy and insolvency. There are three aspects of bankruptcy and insolvency regimes which deserve introduction at this stage.

First, most generally, it is not surprising that bankruptcy was subject to a wideranging overhaul in the 19th century.<sup>148</sup> Earlier bankruptcy regimes created

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<sup>144</sup> For example, *Contracts Review Act 1980* (NSW).

<sup>145</sup> *Trade Practices Act 1974* (Cth) Part IVA.

<sup>146</sup> (1751) 2 Ves Sen 125; 28 ER 82.

<sup>147</sup> See generally Parkinson, above n 124.

<sup>148</sup> For a comprehensive discussion of this process see V Markham Lester, *Victorian Insolvency, Bankruptcy, Imprisonment for Debt, and Company Winding-up in Nineteenth-Century England*, (1995). Note also Cornish and Clark, above n 43, 226-237.

unnecessary uncertainty, fraud and abuse.<sup>149</sup> The bankruptcy and insolvency regimes which operate in the 20th century are the products of this reform process.

Secondly, despite the 19th century reform process, certain fundamental principles had already been well established by 1800.<sup>150</sup> The principle of rateable distribution between unsecured creditors had been settled. The principle stems in part from the Roman law of *bonorum venditio*.<sup>151</sup> In the Middle Ages, the law of *bonorum venditio* was adopted by the Italian City States which were leaders in commerce,<sup>152</sup> the development of commercial law and the concept of modern bankruptcy itself.<sup>153</sup>

In early English law, there was no formal law of bankruptcy.<sup>154</sup> However, in the reign of Henry VIII, the Parliament enacted 'An Act Against Such Persons As Do Make Bankrupt',<sup>155</sup> which established the principle that the money realised from the assets of the bankrupt were to be rateably distributed amongst creditors.<sup>156</sup> In *Smith v Mills*,<sup>157</sup> the Court stated:

but the law, as hath been said before, hath appointed certain commissioners of indifferency and credit, to make the distribution of his goods to every one of his creditors, rate and rate alike, a portion, according to the quantity of their debts, as the statute speaketh.<sup>158</sup>

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<sup>149</sup> Lester, above n 148, 25-26.

<sup>150</sup> Ibid 37.

<sup>151</sup> HF Jolowicz, *Historical Introduction to the Study of Roman Law* (2<sup>nd</sup> ed, 1952) 225.

<sup>152</sup> Wyndham Antis Bewes, *The Romance of the Law Merchant: Being an Introduction to the Study of International and Commercial Law with some Account of the Commerce and Fairs of the Middle Ages* (1923) 57-58. Note also Holdsworth, above n 132, vol 8, 229-230.

<sup>153</sup> Ibid 61-62.

<sup>154</sup> Lester, above n 148, 13-14; Dennis Rose, *Lewis: Australian Bankruptcy Law* (10<sup>th</sup> ed, 1994) 7-8.

<sup>155</sup> 34 & 35 HenVIII c 4.

<sup>156</sup> Rose, above n 154, 11; Lester, above n 148, 14.

<sup>157</sup> (1584) 2 Co Rep 25a; 76 ER 441.

<sup>158</sup> Ibid 26a; 473-474.

From then onward, the principle sustained remarkable currency and it appears that it was not challenged directly thereafter, despite the passage of numerous statutes.<sup>159</sup> No doubt the principle of rateable distribution would not have conflicted with 19th century utilitarianism because it was a straightforward, easily understood, disarmingly simple to apply and apparently fair. As Atiyah's discussion has indicated, the principle of rateable distribution of assets was not only unchallenged, but the commercial community sought to have the principle applied more vigorously.<sup>160</sup> In the 20th century, the rateable distribution principles remains entrenched in legislation.<sup>161</sup>

The principle of rateable distribution is relevant because it is a compelling reason for legislative and judicial non-intervention in commercial relationships where one party has become insolvent. Non-intervention preserves the certainty and fairness of the rateable distribution principle. The argument is that to do otherwise would artificially deplete the assets of the bankrupt. This argument is addressed in Chapter 4.

However, when considering the principle of rateable distribution, qualifications are necessary. The operation of rateable distribution of assets has been undercut by prioritisation of certain unsecured creditors under legislation. Certain claims by unsecured creditors are given automatic priority over other unsecured creditors.<sup>162</sup> The concept of the secured creditor dramatically limits the operation of rateable distribution because the security effectively removes the asset from distribution amongst unsecured creditors until the secured creditor has been fully paid out.<sup>163</sup> Commercial persons have turned to other means, such as the limited liability company (and even arranged the assets of the company so as to take them preferentially on winding up), to prevent personal bankruptcy and the operation of the principle.<sup>164</sup>

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<sup>159</sup> For a discussion of the complex array of statutes see Rose above, n 154, 10-16.

<sup>160</sup> Atiyah, above n 74, 519.

<sup>161</sup> Ibid; For a discussion of the history of Australian bankruptcy law see Rose, above n 154, 17-18.

<sup>162</sup> *Bankruptcy Act 1966* (Cth) s 109(1).

<sup>163</sup> *Bankruptcy Act 1966* (Cth) s 90.

<sup>164</sup> Cornish and Clark, above n 43, 236; *Salomon v A Salomon & Co Ltd* [1897] AC 22. For a modern application of the doctrine see *Lee v Lee's Air Farming Ltd* [1961] AC 12 and *Hamilton v Whitehouse* (1988) 82 ALR 626. For a discussion of the modern scope and limitations of the doctrine see HAJ

Thirdly, there have been occasions where equity has been used to alleviate the harsh results of an untrammelled operation of rateable distribution. The problem is that the principle does not distinguish between different kinds of creditors (other than on the basis of whether the creditor is secured or unsecured). Therefore, the circumstances which surround the transfer, the collection of money by a debtor or the retention of money by a debtor is never investigated. Thus, equity has been used as a supplement to bankruptcy and insolvency regimes where the application of the rateable distribution principle is involved. The application of equitable principles has arisen in two separate and complementary contexts.

The first situation is the interpolation of the principle into bankruptcy law that a trustee in bankruptcy is an officer of the court who should not abuse his or her powers. Therefore, in the 19th century authority of *Ex parte James; Re Condon*,<sup>165</sup> it was made clear that equitable principles were applicable to the process of bankruptcy administration. James LJ stated:

I am of opinion that a trustee in bankruptcy is an officer of the Court. He has inquisitorial powers given him by the Court, and the Court regards him as its officer, and he is to hold money in his hands upon trust for its equitable distribution among the creditors. The Court, then, finding that he has in his hands money which in equity belongs to some one else, ought to set an example to the world by paying it to the person really entitled to it. In my opinion the Court of Bankruptcy ought to be as honest as other people.<sup>166</sup>

The basic principles are that there must be an enrichment of the estate,<sup>167</sup> the claimant must not be in a position to submit an ordinary proof of debt<sup>168</sup> and it would be contrary to 'fair dealing' for the trustee to retain the moneys for the purpose of pro rata distribution to creditors<sup>169</sup> or it would be unfair for the trustee to rely upon his

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Ford, RP Austin and IM Ramsay, *Ford's Principles of Corporations Law* (8<sup>th</sup> ed, 1997) [4.140]-[4.420].

<sup>165</sup> (1874) LR 9 Ch App 609.

<sup>166</sup> *Ibid* 614.

<sup>167</sup> *Re Clark (A Bankrupt); Ex parte The Trustee v Texaco Ltd* [1975] 1 WLR 559, 563-4; *Re Ayoub; Ex parte Silvia* (1983) 67 FLR 144, 148 (Morling J); *Re Sabri; Ex parte Brien v Australia and New Zealand Banking Group Ltd* [1996-1997] 21 Fam LR 213, 232 (Chisolm J).

<sup>168</sup> *Ibid*.

<sup>169</sup> *Re Tyler; Ex parte The Official Receiver* [1907] 1 KB 865, 872 (Farrell LJ).

strict legal rights.<sup>170</sup> In some cases, judges have indicated that they would exercise equitable jurisdiction in order to ensure that the administrator acts in such a way as to ensure that there has been honest dealing.<sup>171</sup> However, whilst there has been some discussion of what sort of conduct would not amount to fair dealing,<sup>172</sup> it appears that the kinds of situations involved are not fully delineated. The principle enunciated in *Ex parte James* is consistent with the underlying assumption in bankruptcy law that the trustee in bankruptcy acquires no better title than the bankrupt.<sup>173</sup>

The other method by which courts have been able to moderate the application of the principle of rateable distribution is by determining that the debtor held the money in trust for the creditor. This principle does not operate in relation to express trusts based on intention only. Rather, it is equally effective in relation to the diverse range of trusts which operate in our legal system.<sup>174</sup> However, the trust property must be identified.<sup>175</sup> It is not surprising that litigants and courts alike have focussed on the existence of a trust. It is a well accepted principle of the administration of bankruptcy and insolvency regimes that money which is held in trust does not form part of the assets of the debtor.<sup>176</sup> Therefore, the beneficial interest in the asset is patriated in, or repatriated into the hands of the creditor as beneficiary. In many cases, there is no question that a trust operates and the property which is subject to the trust is clearly identifiable. Far more difficult are those cases where a creditor alleges that there is a trust operating in its favour, but there is no clearly expressed trust regulating the relationship between the parties and/or the property which is alleged to be subject of the trust is not clearly identifiable or traceable. In order to

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<sup>170</sup> *Re Clark (A Bankrupt); Ex parte The Trustee v Texaco Ltd* [1975] 1 WLR 559, 563-4; *Re Ayoub; Ex parte Silvia* (1983) 67 FLR 144, 148 (Morling J); *Re Sabri; Ex parte Brien v Australia and New Zealand Banking Group Ltd* (1996-1997) 21 Fam LR 213, 232 (Chisolm J).

<sup>171</sup> *Re Craig & Sons; Ex parte Hinchcliffe* [1916] 2 KB 497; *Re Regent Finance & Guarantee Corp* [1930] WN (Eng) 84; *Re Henderson; Ex parte Tonkin* (1934) 7 ABC 273; *Re Docker; Ex parte Official Receiver* (1938) 10 ABC 97; *Re Sabri; Ex parte Brien v Australia & New Zealand Group Ltd* (1996-1997) 21 Fam LR, 213. For a full list of cases where the principle has been referred to and/or applied see PP McQuade and MGR Gronow, *McDonald, Henry and Meek: Australian Bankruptcy Law and Practice* (5<sup>th</sup> ed, 1996) vol 1, [116.1.310].

<sup>172</sup> *Re Tyler; Ex parte The Official Receiver* [1907] 1 KB 865, 872-873 (Farwell LJ).

<sup>173</sup> McQuade and Gronow, vol 1 above n 171, [116.1.320].

<sup>174</sup> RP Meagher and WMC Gummow, *Jacobs' Law of Trusts in Australia* (6<sup>th</sup> ed, 1997) Chapter 3.

<sup>175</sup> McQuade and Gronow, above n 171 vol 1, [116.2 .10].

<sup>176</sup> *Bankruptcy Act 1966* (Cth) s 116 (2) (a).

find and justify a trust, courts have embraced a broadened notion of an intention to create an express trust and in so doing, courts (and commentators) have relied on the specificity and identifiability of the property which is allegedly subject to a trust. In recent years courts of various common law jurisdictions have turned to the consideration of constructive trust in commercial transactions,<sup>177</sup> but this process has been sporadic, incompletely formulated and, in some cases, the guidelines which have been enunciated have been unnecessarily restrictive.<sup>178</sup>

This thesis will explore both doctrinally and practically the appropriate test and appropriate legal mechanism which should be applied when determining whether the funds form part of the assets of the bankrupt debtor. It will be argued that closer examination of the principle of unconscionability in equity is required.

Hereafter, for ease of discussion the words 'insolvent' and 'insolvency' will be used in preference to 'bankrupt' and 'bankruptcy' to encompass the failure of an individual, partnership or corporation to meet their debts as and when they fall due (except where specific bankruptcy legislation is discussed).<sup>179</sup> So too, reference will be made to insolvency administrators rather than trustees in bankruptcy, receivers and liquidators for ease of expression. The discussion of insolvency issues will particularly focus on the *Bankruptcy Act 1966* (Cth).

## VI EQUITY AND RESTITUTION

The fifth and final contextual area is the relationship of equity and restitution in the context of commercial transactions and bankruptcy.

The law of restitution has revived in recent years in Australia and England<sup>180</sup> as a response to commercial situations which require judicial intervention but which

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<sup>177</sup> For example Gerard McCormack, 'The Remedial Constructive Trust and Commercial Transactions' (1996) 17 *The Company Lawyer* 3; DWM Waters, 'The Nature of the Remedial Constructive Trust' in Peter Birks (ed), *The Frontiers of Liability* (1994) vol 2, 165; Paul Finn, 'Constructive Trusts - A New Era, Equity Commerce and Remedy' (Paper presented at the 1993 New Zealand Law Conference, Wellington New Zealand, 2-5 March 1993) vol 1, 203, 224.

<sup>178</sup> For example *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669, 711-716 (Lord Browne-Wilkinson).

<sup>179</sup> *Corporations Law* (Cth) s 95A; *Sandell v Porter* (1966) 115 CLR 666. Note also *Bankruptcy Act 1966* (Cth) s 122 (4) (c) and *Hymix Concrete Ltd v Garrity* (1977) 13 ALR 231.

<sup>180</sup> *Pavey & Matthews Pty Ltd v Paul* (1987) 162 CLR 221; *Lipkin Gorman (A Firm) v Karpnale Ltd* [1991] 2 AC 548.

do not fall neatly into the categorisation of contract and tort law. A major component of any definition of the law of restitution has been the area of common law quasi-contract.<sup>181</sup> The modern law of restitution is based on the concept of unjust enrichment rather than the earlier fiction of implied contract.<sup>182</sup> Goff and Jones have stated in relation to the principle of 'Unjust enrichment' that:

Most mature systems of law have found it necessary to provide, outside the fields of contract and civil wrongs, for the restoration of benefits on grounds of unjust enrichment. There are many civil circumstances in which a defendant may find himself in possession of a benefit which, in justice, he should restore to the plaintiff. Obvious examples are where the plaintiff has himself conferred the benefit on the defendant through mistake or compulsion. To allow the defendant to retain such a benefit would result in his being unjustly enriched at the plaintiff's expense, and this, subject to certain defined limits, the law will not allow. 'Unjust enrichment' is, simply, the name which is commonly given to the principle of justice which the law recognises and gives effect to in a wide variety of claims of this kind.<sup>183</sup>

Such an endorsement of unjust enrichment as the coherent and consistent concept underlying the law of restitution has been forcefully criticised and a generalised right to restitution rejected by some commentators.<sup>184</sup> Nevertheless, the breadth of the concept of unjust enrichment has resulted in two phenomena. First, advocates of the law of restitution have expanded the notion of unjust enrichment well beyond quasi-contract. They have subsumed and rationalised areas which are the traditional domain of equity.<sup>185</sup> Such rationalisations are interesting academic exercises but remain unsatisfactory because these doctrines are the creation of the conscience of equity rather than the relatively modern notion of unjust enrichment.

Secondly, in recent times, restitution commentators have sought to endow the concept of unjust enrichment with proprietary features which the original law of quasi-contract did not possess. The problem for the modern restitution commentators

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<sup>181</sup> Goff and Jones, above n 114, 3-5.

<sup>182</sup> Ibid 5- 11.

<sup>183</sup> Ibid 12-13.

<sup>184</sup> Steve Hedley, 'Unjust Enrichment as the basis of Restitution - an overworked concept' (1985) 5 *Legal Studies* 56.

<sup>185</sup> See for example, Goff and Jones, above n 114, Chapters 33, 10 and 11; Keith Mason and JW Carter, *Restitution Law in Australia* (1995) Chapter 17.

is that a successful claimant obtains a personal remedy only. Where the party who has been unjustly enriched is insolvent, restitution lawyers have found their elaborate and cohesive scheme severely wanting. And, they have had to consider the prospect of invoking the jurisdiction of equity. The schemes presented by restitution lawyers have been generally unsatisfying in this regard.<sup>186</sup>

One possible reason for the apparent friction between equity lawyers and restitution lawyers may rest in the fact that both equity and quasi-contract were tools of judicial intervention in commercial transactions. Judicial intervention was uncoordinated, due to the laissez-faire attitude of 19th century courts and the administration of the 'courts' system up to the passing of the *Judicature Act* in 1873. Thus, there has been overlapping jurisdictions in relation to some kinds of matters. But, equity was (and is) the primary tool for judicial intervention and equitable principles govern the award of equitable proprietary relief.

Therefore, a focus of this thesis will be where a so-called restitutionary claimant requires a proprietary remedy because of the insolvency of the defendant. It is submitted that the answer to the question whether an unsecured creditor is entitled to a proprietary remedy is inevitably linked to how equity has and should define unconscionable conduct with reference to commercial risk and the conduct of commercial parties.

## VII PLAN OF THE THESIS

The thesis is divided into two parts. Part One comprises Chapters 2, 3 and 4. Part Two comprises Chapters 5, 6 and 7.

In Part One, there is a consideration of the use and abuse of proprietary interests and relief in our legal system in the context of insolvency. Chapter 2 is concerned with the comparison between personal and proprietary interests and remedies and the various situations where equity has traditionally recognised proprietary interests. It is contended that equitable intervention can be explained not only on the basis of unconscionability, but also on the basis of risk assumption. These concepts are not mutually exclusive. The concept of unconscionable conduct has subsumed the commercial notion of risk. Chapters 3 and 4 deal with the problem of trying to extend equity's proprietary reach. Chapter 3 deals with the relatively

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<sup>186</sup> See the discussion in Chapter 3, 122-129; Chapter 5, 199-201.



recent extension of proprietary interests and adaptations considered in Chapter 2 and the doctrinal problems which these extensions present. However, some extensions are explicable on the basis of risk assumption as well. Turning from the attempts to extend equitable proprietary mechanisms, it is contended in Chapter 4 that the traditional requirement for a proprietary base for the operation of equity's rules is no longer tenable in the modern age - particularly where money is concerned.

Part Two deals with development and enhancement of the principle of unconscionability in recent times; and the importance of risk assumption as an integral part of the equity's characterisation of unconscionable conduct. Chapter 5 directly confronts the meaning and applicability of unconscionable conduct. It is contended that we are moving towards a theory of objective non-assumption of risk. Chapter 6 details the practical application of the theory of objective non-assumption of risk. Chapter 7 considers what is the appropriate remedy where there has been an objective non-assumption of risk; and any possible defences.

A conclusion:

- (i) summarises the arguments and findings of the thesis; and
- (ii) considers the potential impact of the thesis findings on the way equity may operate in the future, particularly in relation to insolvency administration.

## **PART ONE**

### **EQUITABLE PROPRIETARY GATEWAYS AND THE PROPRIETARY BASE THEORY**

## **Chapter 2**

### **EQUITABLE PROPRIETARY INTERESTS: TRADITIONAL APPROACHES**

## I INTRODUCTION

This chapter analyses how equity's proprietary devices have traditionally operated in insolvency contexts. In order to do so, it will be necessary to consider the equitable mechanisms and the underlying rationale for them. The early concept of 'conscience' has informed the development of equitable proprietary devices. However, this concept of conscience has a modern secular focus - risk assumption in commercial transactions.

## II PERSONAL AND PROPRIETARY INTERESTS

A starting point for a consideration of equity's traditional proprietary impact in insolvency contexts is a consideration of the well known divide between personal interests or claims in personam and proprietary interests or claims in rem. Personal claims exist against a specific person such as a claim for debt or breach of contract.<sup>1</sup> A claim in rem is a right or claim which operates against the world at large.<sup>2</sup> Generally, a claim in rem will function in the context of proprietary interests and relief. However, this is not always the case. Sykes and Walker have pointed out that claims in rem may operate without the need for property at all:

Such a right is frequently proprietary in the sense of being available in relation to a piece of tangible property, but the phrase is also used to cover rights in tort which are not proprietary. A right not to be assaulted or a right not to be maliciously prosecuted is a right in rem but is not proprietary. Conversely, neither security nor ownership rights over 'property' are necessarily available against all the world. Whether they are depends on the nature of the res. A mortgagee of land gets rights available against all the world because of the nature of the res. However, modern commercial and legal development has uncovered an increasing number of interests which can be made the subject of ownership. A mere debt is now regarded as a res, a thing which one can own, dispose of and make the subject matter of a security. But a debt is a mere right in personam; the person entitled to it can, therefore, in making it available as the subject matter of a

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<sup>1</sup> Edward I Sykes and Sally Walker, *The Law of Securities* (5<sup>th</sup> ed, 1993) 4.

<sup>2</sup> *Ibid* 4, 8.

security, give to the security holder nothing but a mere right in personam.<sup>3</sup>

However, a substantial portion of in rem claims will be directed at some forms of property (although increasingly such claims are becoming detached from tangible property).<sup>4</sup> Such proprietary rights or rights in re<sup>5</sup> are of two kinds. First there are proprietary rights based on the ownership of a res. A person has the ownership of a res where that person

has a collection or aggregation of rights in re, such as the rights of possession and of enjoyment and the right of transfer or disposal of the res.<sup>6</sup>

Secondly, there are security rights in re where a secured creditor may obtain ownership of property (such as under an equitable mortgage), a mere charge over the property or something in between these two extremes.<sup>7</sup> For the purposes of the subsequent discussion, the concept of security is defined:

...as an interest, not being an interest arising from a trust, in property which is either owned by another person or in which another person has incomplete or inchoate rights capable of maturing into full ownership, by virtue of which interest certain rights are exercisable in relation to that property in order to obtain payment or performance of an obligation by that other person either consensually provided for or provided for by implication of law or validly directed by some third party to be paid or performed.<sup>8</sup>

Such interests in re are highly effective in insolvency contexts. If it can be established that the insolvent does not own certain property, then that property will not form part of the asset base of the insolvent. It will not be property owned or vested in the insolvent or the insolvency administrator.<sup>9</sup> Therefore, it is not

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<sup>3</sup> Ibid 8.

<sup>4</sup> Ibid.

<sup>5</sup> Ibid 7.

<sup>6</sup> Ibid.

<sup>7</sup> Ibid.

<sup>8</sup> Ibid 12.

<sup>9</sup> Note generally *Bankruptcy Act 1966* (Cth) s 116 (1).

surprising that elaborate title retention schemes have surfaced.<sup>10</sup> On the other hand, secured creditors are accorded special treatment under insolvency regimes. They may realise their securities outside of the insolvency regime and they stand ahead of unsecured creditors.<sup>11</sup> Equity developed two different mechanisms which, broadly speaking, fall within the concept of proprietary interests. There are proprietary interests in which a party acquires an equitable interest in the underlying property such as the equitable interests which beneficiaries acquire in trust property.<sup>12</sup> Alternatively, there are security interests, such as the lien or the floating charge or lien, under which a party acquires a security interest over, but not in, another person's property.

Various equitable proprietary devices which have operated effectively in insolvency contexts will be considered. What needs to be emphasised here is that this chapter is primarily concerned with proprietary interests and security devices which stand outside traditional commercial transactions by which parties consensually agree to shift the burden of risk. Therefore, equitable mortgages<sup>13</sup> and floating and fixed charges<sup>14</sup> will not be discussed. Such consensual devices create a situation where a creditor has a priority interest by virtue of the fact that he is a secured creditor.

### III ASSUMPTION OF RISK

The second important feature to re-iterate is that equity has transcended its original family and domestic origins.<sup>15</sup> Equity is such an important jurisdiction with respect to commercial transactions that it has absorbed significant general concepts which flow through the commercial process. Increasingly, as a means of explaining

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<sup>10</sup> See for example, Sarah Worthington, *Proprietary Interests in Commercial Transactions* (1996) Chapter 2.

<sup>11</sup> *Bankruptcy Act 1966* (Cth) s 90.

<sup>12</sup> See below, 50-55; cf discretionary trusts: *Gartside v Inland Revenue Commissioners* [1968] AC 553; IJ Hardingham and R Baxt, *Discretionary Trusts* (2<sup>nd</sup> ed, 1984) [605]-[609].

<sup>13</sup> For a discussion of the equitable mortgage see Sykes and Walker, above n 1, 307-319.

<sup>14</sup> *Ibid* 193-199.

<sup>15</sup> For a discussion of the origins of equity and the trust in England see William Holdsworth, *A History of English Law* (2<sup>nd</sup> ed, 1937) vol 1, 395-423 and vol 4, 407-480.

existing equitable mechanisms and defining unconscionable conduct, modern courts have referred to the need to determine whether a party assumes the risks which commercial transactions present. Thus, risk, an inherent factor in commercial transactions, is becoming an important determinant of equitable intervention. An early United States case, *Re Kountze Bros*<sup>16</sup> established that equity operated increasingly as a means by which courts examined the assumption of risk. In that case, a private bank was adjudicated bankrupt. A series of appellants argued that funds had been forwarded to the private bank as agent and trustee for them. The problem was that funds had been mixed and the issue was how equity's tracing rules should be applied. The Circuit Court of Appeal stated:

The usual formula is to say that, where a fund is composed partly of the defrauded claimant's money and partly of the fiduciary's own money, the fiduciary is presumed to intend to draw out the money he can legally use rather than that of the claimant... Equity marshals the withdrawals against the fiduciary's own funds so long as it can because that result is deemed fairer. There is good reason for this because the fiduciary's creditors have accepted the risk of his solvency, while his cestuis have accepted only the risk of his honesty.<sup>17</sup>

A similar approach was taken in *Australian Securities Commission v Melbourne Asset Management Nominees Pty Ltd (Receivers and Managers Appointed)*<sup>18</sup> where Northrop J stated in relation to fiduciary obligations of fund recipients for prescribed schemes:

If MAM and Nominees had administered the scheme properly, the funds would not have become intermingled with the general funds of MAM. The investors were relying on the honesty and integrity of MAM and Nominees to administer the scheme properly so that such intermingling did not occur and that MAM would not use the investors' funds for its own purposes. The unsecured creditors, on the other hand, stood in the same position as any normal unsecured creditor in dealing with MAM; they accepted the risk that, as with any other unsecured creditor, MAM may become insolvent and that they may not receive what was owing to them. The investors did not accept

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<sup>16</sup> 79 F 98 (2<sup>nd</sup> Cir, 1935). This case was cited in *Stephenson Nominees Pty Ltd v Official Receiver; Ex parte Roberts* (1987) 16 FCR 536, 556 (Gummow J).

<sup>17</sup> Ibid 101-102.

<sup>18</sup> (1994) 49 FCR 334.

such a risk and should not have been exposed to such a risk, given the fiduciary obligation of MAM to use their funds for a specified purpose only. For these reasons... the investors should be given priority over the unsecured creditors.<sup>19</sup>

In a Privy Council case, *Royal Brunei Airlines Sdn Bhd v Tan*<sup>20</sup> Lord Nichols, who delivered judgment, pointed out that beneficiaries do not take on the risk of loss or insolvency when a trustee has acted in an unauthorised way:

All investment involves risk. Imprudence is not dishonesty, although imprudence may be carried recklessly to lengths which call into question the honesty of the person making the decision. This is especially so if the transaction serves another purpose in which that person has an interest of his own.

This type of risk is to be sharply distinguished from the case where a trustee, with or without the benefit of advice, is aware that a particular investment or application of trust property is outside his powers, but nevertheless he decides to proceed in the belief or hope that his will be beneficial to the beneficiaries or, at least, not prejudicial to them. He takes a risk that a clearly unauthorised transaction will not cause loss. A risk of this nature is for the account of those who take it. If the risk materialises and causes loss, those who knowingly took the risk will be accountable accordingly.<sup>21</sup>

If there is loss arising from the unauthorised use and employment of the trust funds, the unauthorised trustee (whether acting wrongfully or ignorantly), must bear the loss and personally re-imburse the trust assets.<sup>22</sup>

The views expressed in these cases have won some academic endorsement in the United States,<sup>23</sup> England,<sup>24</sup> Canada,<sup>25</sup> Australia<sup>26</sup> New Zealand<sup>27</sup> and Ireland<sup>28</sup> in

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<sup>19</sup> Ibid 359.

<sup>20</sup> [1995] 2 AC 398.

<sup>21</sup> Ibid 389-390.

<sup>22</sup> RP Meagher and WMC Gummow, *Jacobs' Law of Trusts in Australia* (6<sup>th</sup> ed, 1997)[2205]-[2206]; HAJ Ford and WA Lee, *Principles of the Law of Trusts* (3<sup>rd</sup> ed, 1996) [17110]-17120].

<sup>23</sup> George E Palmer, *The Law of Restitution* (1978) vol 1, [2.14], 185-186.

<sup>24</sup> For example, Jill E Martin, *Hanbury & Martin: Modern Equity* (14<sup>th</sup> ed, 1993), 642 - but note the omission in Jill E Martin *Hanbury & Martin: Modern Equity* (15<sup>th</sup> ed, 1997) 657; Lord Goff of Chieveley and Gareth Jones, *The Law of Restitution* (4<sup>th</sup> ed, 1993) 94-95; Gareth Jones, 'Tracing Claims in the Modern World' [1988-1989] *King's Counsel* 15.



the sense that some commentators have considered that assumption of risk is an increasingly helpful criterion for determining when equity should intervene in commercial relationships.

A crucial aspect of defining risk taking in commercial relationships has been the issue of disclosure which was introduced in the discussion of *uberrima fides*.<sup>29</sup> The traditional reluctance to impose duties of disclosure<sup>30</sup> has given way to a greater acceptance of the need for courts and legislatures to impose disclosure obligations on commercial parties.<sup>31</sup> Finn has stated in this regard:

A rigid insistence upon the caveat emptor rule is now acknowledged to be capable of producing 'singularly unappetising' results in some instances. As a consequence there is an emerging trend to insist upon disclosure to prevent undue advantage taking in dealings and this in recognition of the view that there is a widening 'array of contexts where one party's superior knowledge of essential facts renders a transaction without disclosure inherently unfair.'<sup>32</sup>

In the general law, in order to ensure that commercial transactions proceed smoothly and that parties understand the risks they are taking, elaborate procedures

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<sup>25</sup> See generally David M Paciocco, 'The Remedial Constructive Trust: A Principled Basis for Priorities over Creditors' (1989) 68 *The Canadian Bar Review* 315 noting difficulties at 324-325.

<sup>26</sup> John Glover, 'Equity, Restitution and the Proprietary Recovery of Value' (1991) 14 *The University of New South Wales Law Journal*, 247, 276-277; John Glover, *Commercial Equity: Fiduciary Relationships* (1995) [6.61]-[6.66]; Paul Finn, 'Constructive Trusts - A New Era, Equity Commerce and Remedy' (Paper presented at the 1993 New Zealand Law Conference, Wellington New Zealand, 2-5 March 1993) vol 1, 203; David M Wright, *The Remedial Constructive Trust* (1998) [4.20]-[4.25].

<sup>27</sup> SR Scott, *The Remedial Constructive Trust in Commercial Transactions* [1993] *Lloyd's Maritime and Commercial Law Quarterly* 330, 341.

<sup>28</sup> Paul R Coughlan, 'Equitable Liens for the Recovery of Book Deposits' (1987) 9 *Dublin University Law Journal* 65, 104-106.

<sup>29</sup> Chapter 1, 24-26.

<sup>30</sup> Tina Cockburn and Leanne Wiseman, 'Introduction: Disclosure Obligations of Business: Contemporary Issues' in Tina Cockburn and Leanne Wiseman (eds), *Disclosure Obligations in Business Relationships* (1996) 1, 3-7.

<sup>31</sup> *Ibid* 7-14.

<sup>32</sup> Paul Finn, 'Contract and the Fiduciary Principle' (1989) 12 *The University of New South Wales Law Journal* 76, 78.

have been set up in relation to investment schemes and consumer transactions. The complex law concerning corporate prospectuses<sup>33</sup> and consumer protection<sup>34</sup> are conspicuous examples.

In determining whether equitable proprietary intervention is warranted, courts have increasingly considered whether the party knew all the relevant information in relation to the transaction. In *Barclays Bank plc v O'Brien*,<sup>35</sup> the House of Lords considered the nature and extent of the doctrine of undue influence in the context of wives providing security for the liabilities of husbands.<sup>36</sup> The House of Lords held, inter alia, that third party lenders such as Barclays Bank, could not simply rely on written documentation in order to obtain reliable security for funds which had been lent or would be lent in the future. The third party lender would be fixed with constructive notice of any undue influence exerted by the husband over the wife.<sup>37</sup> In short, what the third party lenders were obliged to ensure was that the wife understood the commercial risk she was taking when acting as guarantor. Therefore, Lord Browne-Wilkinson stated:

But in my judgment the creditor, in order to avoid being fixed with constructive notice, can reasonably be expected to take steps to bring home to the wife the risk she is running by standing as surety and to advise her to take independent advice. As to past transactions, it will depend on the facts of each case whether the steps taken by the creditor satisfy this test. However for the future in my judgment a creditor will have satisfied these requirements if it insists that the wife attend a private meeting (in the absence of the husband) with a representative of the creditor at which she is told of the extent of her liability as surety, warned of the risk she is running and urged to take independent legal advice. If these steps are taken in my judgment the

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<sup>33</sup> *Corporations Law* (Cth) Part 7.12; Simon Fisher, 'Disclosure Obligations Specific to Corporations' in Tina Cockburn and Leanne Wiseman (eds), *Disclosure Obligations in Business Relationships* (1996) 212.

<sup>34</sup> *Trade Practices Act 1974* (Cth) Part V; Sharon Christensen, 'The Effect of the Trade Practices Act on Non-disclosure' in Tina Cockburn and Leanne Wiseman (eds), *Disclosure Obligations in Business Relationships* (1996) 92.

<sup>35</sup> [1994] 1 AC 180.

<sup>36</sup> For a discussion of the complex contextual issues see Belinda Fehlberg, *Sexually Transmitted Debt* (1997).

<sup>37</sup> See also the judgment of Kirby J in *Garcia v National Australia Bank Ltd* (1998) 155 ALR 614, [70]-[83].

creditor will have taken such reasonable steps as are necessary to preclude a subsequent claim that it had constructive notice of the wife's rights.<sup>38</sup>

The judgment showed that, at least in some cases, undue influence is not primarily focussed on the voluntariness of a party, but on whether the party has assumed the risk of the transaction fully informed about the possible affect of the transaction on her personal interests. Once the third party lender had redressed the potential vitiating factor of non-disclosure, it could enforce the transaction on the basis that it was a conventional commercial transaction where it could be safely assumed that the other party understood and assumed commercial risk. In this case, the wife did not seek proprietary relief but rescission. Rescission was appropriate because it restored her to the situation prior to the execution of the guarantee. Such an effective personal remedy (which had a proprietary effect of nullifying the mortgage over the house) would not have been available if there had been disclosure.

In the recent case, *Garcia v National Australia Bank Ltd*<sup>39</sup> a majority of the High Court upheld the decision of Dixon J in *Yerkey v Jones*<sup>40</sup> and declined to follow the *O'Brien* approach.<sup>41</sup> However, they effectively determined that risk assumption was at the heart of cases where a wife, as a volunteer, guaranteed her husband's debts. They held that a bank's enforcement of such a guarantee would constitute unconscionable conduct, if the bank had not explained the transaction to the wife or was not aware of the wife having obtained appropriate independent advice. Thus, it would be unconscionable to enforce a guarantee against a wife who did not understand the risks associated with the guarantee.<sup>42</sup>

The associated, but still different, doctrine<sup>43</sup> of unconscionable dealings can also be explained on the basis that there has been a lack of informed risk assumption.

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<sup>38</sup> *Barclays Bank plc v O'Brien* [1994] 1 AC 180, 196-197.

<sup>39</sup> *Garcia v National Australia Bank Ltd* (1998) 155 ALR 614.

<sup>40</sup> (1939) 63 CLR 649.

<sup>41</sup> (1998) 155 ALR 614, [39] (Gaudron, McHugh, Gummow and Hayne JJ).

<sup>42</sup> *Ibid* [31]-[33], [41]. For a further discussion of the case see Chapter 5, 194-195.

<sup>43</sup> See IJ Hardingham, 'Unconscionable Dealing' in PD Finn (ed), *Essays in Equity* (1985) 1 and the recent decision of the High Court of Australia, *Garcia v National Australia Bank Ltd* (1998) 155 ALR 614, [26]-[30].

The doctrine is triggered by the unscrupulous taking advantage of another person's special disabilities which may include for example, poverty,<sup>44</sup> poor health,<sup>45</sup> lack of education or language difficulties<sup>46</sup> or lack of business expertise.<sup>47</sup> Again, evidence of full disclosure of the financial risk and suggestions to take independent advice will redress the obvious informational and personal imbalance, and transform the unconscionability of the transaction into a standard risk assumption venture.

It will be argued that a variety of equitable proprietary mechanisms and equitable doctrines may be explained on the basis that the aggrieved party had not assumed the risk of the transaction. For ease of discussion, these mechanisms and doctrines will be referred to as 'equitable proprietary gateways.'

#### IV THE TRUST, FIDUCIARY OBLIGATIONS AND TRACING

##### *A The Trust*

Commentators have pointed out that it is immensely difficult, if not impossible, to provide a satisfactory definition of the trust.<sup>48</sup> Some have suggested that this is due to the fact that there is a family of trust concepts rather than a single dominating idea.<sup>49</sup> However, what cannot be denied is that the family of trust concepts are concerned with the relationship between various parties and property of one kind or another. Generally, a trust arises where there is a division between legal title and equitable title.<sup>50</sup> However, it must be acknowledged that some trusts, such

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<sup>44</sup> *Vital Finance Corporation Pty Ltd v Taylor* (1991) ASC ¶56-099, ¶57,051 (Smart J).

<sup>45</sup> *Blomley v Ryan* (1956) 99 CLR 362.

<sup>46</sup> *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447.

<sup>47</sup> *Morlend Finance Corp (Vic) Pty Ltd v Luke* (1991) ASC ¶56-095, ¶56, 995 (Smith J); *Vital Finance Corporation Pty Ltd v Taylor* (1991) ASC ¶56-099, ¶57,051 (Smart J).

<sup>48</sup> JD Heydon and PL Loughlan, *Cases and Materials on Equity and Trusts* (5<sup>th</sup> ed, 1997) [22.3.1]; Meagher and Gummow, above n 22, [101]; DWM Waters, *Law of Trusts in Canada*, (2<sup>nd</sup> ed, 1984), 4-5; Jill E Martin, *Hanbury & Martin: Modern Equity* (15<sup>th</sup> ed, 1997) 45.

<sup>49</sup> Heydon and Loughlan, above n 48, [22.3.1].

<sup>50</sup> Meagher and Gummow, above n 22, [105] and [107]; Martin, above n 48, 45-46; *Hardoon v Belilios* [1901] AC 118, 123 (Lord Lindley).

as charitable trusts<sup>51</sup> or non charitable purpose trusts,<sup>52</sup> do not vest equitable proprietary interests in clearly defined beneficiaries. In the latter case, this can result in invalidity. Also, the discretionary trust does not vest beneficiaries with an equitable interest.<sup>53</sup> Nonetheless, the kinds of trusts which will be discussed throughout this thesis will generally conform to the standard criterion that there is a split between legal and equitable ownership.

Equity, via the development of the trust, arose essentially in the context of family and domestic disputes about land and property. Whilst it is true that Aristotle's concept of *epieikeiá*<sup>54</sup> is generally credited with directly influencing Roman law *aequitas*<sup>55</sup> (and thereafter Roman law influenced English equity),<sup>56</sup> such influence did not take place in a vacuum. Generally Roman *aequitas*<sup>57</sup> and English equity were employed to resolve property disputes. Therefore, it is not surprising that records show that when a plaintiff petitioned the Chancellor for redress for a perceived wrong, the perceived wrong was often the fact that one member of a family retained land which did not belong to him.<sup>58</sup>

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<sup>51</sup> Meagher and Gummow above n 22, [1005]; Ford and Lee, above n 22, [19000]-[19010].

<sup>52</sup> Meagher and Gummow, above n 22, Chapter 11; Ford and Lee, above n 22, [5230]-[5310]; *Morice v Bishop of Durham* (1804) 9 Ves 399; 32 ER 656; *Re Denley's Trust Deed* [1969] 1 Ch 372; *Leahy v Attorney-General (NSW)* AC 457; *Bacon v Pianta* [1966] 114 CLR 634.

<sup>53</sup> *Gartside v Inland Revenue Commissioners* [1968] AC 553; *R & I Bank of Western Australia Ltd v Anchorage Investments Pty Ltd* (1992) 10 WAR 59.

<sup>54</sup> See JAK Thomson (trans), *The Ethics of Aristotle: The Nicomachean Ethics* (1976) Book V Chapter 10, 198-200.

<sup>55</sup> JM Kelly, *A Short History on Western Legal Theory* (1992) 52; James Mackintosh, *Roman Law in Modern Practice* (1934) 34 Charles Phineas Sherman, *Roman Law in the Modern World* (1917) vol 1, §65.

<sup>56</sup> See Spencer W Symore (ed), *A Treatise on Equity Jurisprudence*, (5<sup>th</sup> ed, 1941) §2; Sherman, above n 55, §379; cf FW Maitland, *Equity: A Course of Lectures* (1936) 32 and OW Holmes, 'Early English Equity' (1885) 1 *The Law Quarterly Review* 62.

<sup>57</sup> For a discussion of a device in Roman law similar to a trust to address property disputes see David Johnston, *The Roman Law of Trusts* (1988) and Sherman, above n 55, vol 1, § 151.

<sup>58</sup> For a full discussion of these issues and how the use subsequently developed see Holdsworth, above n 15, vol 4, 407-480. For a discussion of the period see RP Meagher, WMC Gummow and JRF Lehané, *Equity Doctrines and Remedies* (3<sup>rd</sup> ed, 1992) [103]- [110].

The importance of such petitions was not simply that they were made in a context in which petitioners appealed to ‘what right and reason demand’<sup>59</sup> or ‘the fulfilment of justice to the parties.’<sup>60</sup> Rather, the Chancellor was called upon to recognise interests in property which were not legal interests, but which were sufficiently defined and meaningful to warrant protection. From these early origins, equity developed proprietary interests as distinct from legal ownership in property. The concept of the trust was a brilliant compromise. On the one hand, equity did not interfere with the legitimacy of the common law concept of ownership. Equity acted as a gloss on the common law in the sense that the legal ownership was subject to a legitimate interest of another.

Thus, ecclesiastical notions of natural law and fairness may have survived in equitable jurisprudence.<sup>61</sup> However, what ultimately gave the trust its historically enduring quality was the development of the proprietary interest which was a central feature of the trust. As Scott and Fratcher have stated:

The trust would never have attained the position it has assumed in English law, however, if the chancellor had contented himself with enforcing the personal duties imposed upon the trustee. He did much more than this. He created a system of equitable ownership. At first, it is true, he did not profess to do this. He spoke as though he were merely compelling the trustee to act in accordance with the dictates of conscience. But before the end of the fifteenth century he had held that the interest of the beneficiary would be protected against purchasers with notice of his interest, against the heir of the trustee, and against gratuitous transferees. It is true that he refused to subject to the trust a purchaser for value and without notice of the beneficiary’s interest. He did not give as complete protection to equitable ownership as the law gave to legal ownership. Before the end of the fifteenth century he treated the beneficiary’s interest as a form of ownership, and not merely as a claim against the trustee, not only as between the beneficiary and the outer world, but as between the beneficiary and his successors in interest.<sup>62</sup>

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<sup>59</sup> William Paley Baildon (ed), ‘Select Cases in Chancery’ (1896) 10 *Seldon Society* Case Number 63.

<sup>60</sup> Ibid Case Number 95.

<sup>61</sup> See The Honourable Sir Anthony Mason, ‘The Place of Equity and Equitable Doctrines in the Contemporary Common Law World: An Australian Perspective’ in Donovan WM Waters (ed), *Equity, Fiduciaries and Trusts* 1993 (1993) 1, 5.

<sup>62</sup> Austin Wakeman Scott and William Franklin Fratcher, *The Law of Trusts* (4<sup>th</sup> ed, 1987) vol I, § 1, 5-6.

The history of the trust (originally known as the use) has been described from the perspective of taxation and primogeniture.<sup>63</sup> However, the use of equitable interests and the trust to circumvent the rigours of bankruptcy law was equally important. Holdsworth has demonstrated that during the 17th century, a party could successfully plead that property, in which he had an equitable interest, could not be considered part of the assets of a bankrupt.<sup>64</sup> Property which had been settled by a relative for the benefit of the wife and children of the bankrupt, was not part of the assets of the bankrupt.<sup>65</sup> The court held that the settlement was not a trust created by the husband.<sup>66</sup> Therefore, during this era, it appears that trusts were used to try to protect assets from creditors, although Holdsworth's account is not specific on this point.

Since that time, the fact that the trust vests an equitable interest has meant that the trust has been a highly effective device against the insolvency of the trustee.<sup>67</sup> Another way of expressing the effect of the trust is to say that a trustee in bankruptcy acquires no better title than the bankrupt.<sup>68</sup> This apparently simple but effective principle of equity and bankruptcy law has been enshrined in bankruptcy legislation of various jurisdictions. In Australia, s 116 (2) (a) *Bankruptcy Act 1966* (Cth) states that certain property is not divisible amongst creditors of the bankrupt including:

property held by the bankrupt in trust for another person;<sup>69</sup>

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<sup>63</sup> Ibid § 1.1-§1.6; HAJ Ford and IJ Hardingham, *Trusts: Commentary and Materials* (1990) 2-3.

<sup>64</sup> Holdsworth, above n 15, vol 8, 241-242.

<sup>65</sup> *Vandenanker v Desbrough* (1689) 2 Vern 96; 23 ER 671.

<sup>66</sup> Ibid.

<sup>67</sup> *Scott v Surman* (1743) Willes 400, 403; 125 ER 1235, 1237; John F Archbold, *The Law and Practice in Bankruptcy as Founded on the Recent Statutes* (5<sup>th</sup> ed, 1834) 192. In relation to executors as trustees see *Winch v Keeley* (1787) 1 TR 619; 99 ER 1284; *Carpenter v Marnell* (1802) 3 Bos & Pul 40; 127 ER 23; *Gardner v Rowe* (1828) 5 Russ 258; 38 ER 1024; *Morgan v Swansea Authority* (1878) 9 Ch D 582, 585 (Jessel MR); *The Governors of St Thomas' Hospital v Richardson* [1910] 1 KB 271, 276-277 (Cozens-Hardy MR).

<sup>68</sup> *Re Gunsbourg* [1920] 2 KB 426; *Pearce v Bastable's Trustee in Bankruptcy* [1901] 2 Ch 122; *Shoolbred v Roberts* [1900] 2 QB 497; *Re Mapleback* (1876) 4 Ch D 150. For a discussion of this principle see PP McQuade and MGR Gronow, *McDonald, Henry and Meek: Australian Bankruptcy Law and Practice* (5<sup>th</sup> ed, 1996) [116.1.320].

<sup>69</sup> For helpful discussions see WA Lee, 'Trusts and Bankruptcy' (1973) 47 *The Australian Law Journal* 365; RP Meagher, 'Insolvency of Trustees' (1979) *The Australian Law Journal* 648.

In the United Kingdom,<sup>70</sup> Canada<sup>71</sup> and the United States<sup>72</sup> the position is similar in relation to bankruptcy. In relation to insolvent corporations it has been noted that in Australia, the *Corporations Law (Cth)* does not expressly exclude trust assets from the assets which are distributable amongst the insolvent's creditors.<sup>73</sup> However, s 556 *Corporations Law* effectively excludes trust assets from those being used to discharge the liabilities of the corporation.<sup>74</sup>

The exclusion of the assets of a trust from the distributable property of the insolvent has been explained in terms of commercial risk. In *Space Investments Ltd v Canadian Imperial Bank of Commerce Trusts Co (Bahamas) Ltd*<sup>75</sup> the Privy Council considered the position of a trustee bank which had become insolvent. The bank, in its capacity as trustee, had properly deposited the trust funds in its own enterprise and the beneficiaries were not entitled to a proprietary interest in the bank's assets. Nevertheless, Lord Templeman (who delivered the judgment for the Privy Council) made some salient remarks about the operation of trusts in insolvency contexts:

This priority is conferred because the customers and other unsecured creditors voluntarily accept the risk that the trustee bank might become insolvent and unable to discharge its obligations in full. On the other hand, the settlor of the trust and the beneficiaries interested under the trust, never accept any risks involved in the possible insolvency of the trustee bank.<sup>76</sup>

And, when comparing the standard of care required from a company director on the one hand and a trustee on the other hand, Finn J stated:

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<sup>70</sup> *Insolvency Act 1986* (UK) s 283 (3) (a); Christopher Berry, Edward Bailey and Stephen Schaw-Miller, *Personal Insolvency – Law and Practice* (2<sup>nd</sup> ed, 1993) [28.1].

<sup>71</sup> *Bankruptcy and Insolvency Act* RSC 1985 c B-3 s 67 (1) (a); The Honourable Mr Justice LW Houlden and CH Morawetz QC, *The 1996 Annotated Bankruptcy and Insolvency Act* (1995) F§ 5.

<sup>72</sup> Scott and Fratcher, above n 62, vol II, § 221,1; Daniel R. Cowans, *Bankruptcy Law and Practice* (2<sup>nd</sup> ed, 1978) vol 1, § 348; Robert D Albergotti, *Understanding Bankruptcy Law in the US: A Handbook of Law and Practice* (1992) 52.

<sup>73</sup> Meagher and Gummow, above n 22, [2114].

<sup>74</sup> *Ibid.*

<sup>75</sup> [1986] 1 WLR 1072.

<sup>76</sup> *Ibid* 1074. See also SJ Stoljar, *The Law of Quasi-Contract* (2<sup>nd</sup> ed, 1989) 142-143.



I would add that underlying the distinction today is, probably, not merely an historical assumption about the separate purposes of companies and of trusts, but also a generalisation about the different risks that persons who invest their assets in companies on the one hand and in trusts on the other are considered likely to have assumed...<sup>77</sup>

In the light of the powerful protection which a trust affords beneficiaries, it is not surprising that provisions excluding the trust property from the assets of the insolvent have been the subject of interpretation. Two major problems have arisen. First, there has been the question whether trust property over which an insolvent trustee has a lien or charge to recoup moneys expended by him for and on behalf of the trust.<sup>78</sup> is protected. It has been established that such entitlements from the trust property were property of the insolvent and were not afforded the protection of the legislative exclusion.<sup>79</sup> Thus, when the trustee becomes insolvent the indemnity which is secured by a right of charge vests in the insolvency administrator.

Secondly, there has been the problem of what does such legislation mean by the word 'trust.' This will be considered below.

### ***B Express or Declared Trusts***

The kind of trust which was under consideration in *Space Investments Ltd v Canadian Imperial Bank of Commerce Trusts Co (Bahamas) Ltd*<sup>80</sup> was an express trust. An express trust has been described as one in which

...the creator has used language which expresses an intention to create a trust. The author of the trust has meant to create a trust, and has used language which explicitly expresses that intention, either orally or in writing. The fact that a trust was intended may even be deduced from

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<sup>77</sup> *Australian Securities Commission v AS Nominees* (1995) 133 ALR 1, 13.

<sup>78</sup> See for example *Vacuum Oil Co Pty Ltd v Wiltshire* (1945) 72 CLR 319.

<sup>79</sup> *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360; *Re Matheson; Ex parte Worrell v Matheson* (1994) 121 ALR 605; 49 FCR 454; *Re McLernon; Ex parte SWF Hoists and Industrial Equipment Pty Ltd v Prebble* (1995) 130 ALR 609; 58 FCR 391; McQuade and Gronow, above n 68, [116.2.057].

<sup>80</sup> [1986] 1 WLR 1072.

the conduct of the parties concerned but, if there is any uncertainty as to intention, there will be no trust.<sup>81</sup>

The standard (but not sole) legal context in which the necessary intention<sup>82</sup> to create an express trust arises is where there is a settlement of a trust deed or a testamentary trust created in writing.<sup>83</sup>

However, this concept of the trust has not been the only kind of trust or relationship which has been protected by the operation of such important provisions as s116 (2) (a) *Bankruptcy Act 1966* (Cth).<sup>84</sup>

### *C The Resulting Trust*

Historically speaking, the trust was the result of a settlor's or a testator's intention. However, even in medieval times, trusts were implied or imposed by the Chancellor. According to Scott and Fratcher, the resulting trust began to emerge in the late 15th century when Chancellors were faced with the problem that proprietary relief was required in cases where a use had not been declared or did not deal with the whole beneficial interest.<sup>85</sup> Holdsworth suggests that the resulting trust emerged later in the 17th century.<sup>86</sup>

The resulting trust has been explained on the basis that it is grounded on an absence of intention to create a trust<sup>87</sup> or because the law intervenes on the basis of what the parties were presumed to have intended.<sup>88</sup> There has been academic debate

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<sup>81</sup> Meagher and Gummow, above n 22 [307]. See also Ford and Lee, above n 22, [2010]- [2060].

<sup>82</sup> *Knight v Knight* (1840) 3 Beav 148; 49 ER 48.

<sup>83</sup> For example *Hayes v National Heart Foundation, NSW Division*, [1976] 1 NSWLR 29; *Dean v Cole* (1921) 30 CLR 1.

<sup>84</sup> Ford and Lee, above n 22 [14100].

<sup>85</sup> Scott and Fratcher, above n 62, vol V § 404, 4-5.

<sup>86</sup> Holdsworth, above n 15, vol 6, 644.

<sup>87</sup> Scott and Fratcher, above n 62, vol V § 404.1, 6.

<sup>88</sup> *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669, 708 (Lord Browne-Wilkinson); Meagher and Gummow, above n 22, [1201].

as to which test is the appropriate one.<sup>89</sup> At the end of the day, the debate can become quite an arid one. Ultimately what is important is that the two approaches are not necessarily inconsistent. Resulting trusts arise by operation of law (whatever the ultimate rationale) and have operated in two situations as Lord Browne-Wilkinson has explained:<sup>90</sup>

(A) where A makes a voluntary payment to B or pays (wholly or in part) for the purchase of property which is vested either in B alone or in the joint names of A and B, there is a presumption that A did not intend to make a gift to B: the money or property is held on trust for A (if he is the sole provider of the money) or in the case of a joint purchase by A and B in shares proportionate to their contributions. It is important to stress that this is only a *presumption*, which presumption is easily rebutted either by the counter-presumption of advancement or by direct evidence of A's intention to make an outright transfer...(B) Where A transfers property to B *on express trusts*, but the trusts declared do not exhaust the whole beneficial interest.<sup>91</sup>

The two kinds of resulting trust were also explained and distinguished by Megarry J in the earlier case, *Re Vandervell's Trusts (No 2)*<sup>92</sup> when he said:

The distinction between the two categories of resulting trusts is important because they operate in different ways. Putting it shortly, in the first category, subject to any provision in the instrument, the matter is one of intention, with the rebuttable presumption of a resulting trust applying if the intention is not manifest. For the second category, there is no mention of any expression of intention in any instrument, or of any presumption of a resulting trust: the resulting trust takes effect by operation of law, and appears to be automatic. What a man fails effectually to dispose of remains automatically vested in him, and no question of any mere presumption can arise. The two categories are thus of presumed resulting trusts and

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<sup>89</sup> Waters, above n 48, 18-20; Robert Chambers, *Resulting Trusts* (1997) 32-34. For a discussion of problems of definition see Wright, above n 26, [6.20].

<sup>90</sup> *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669.

<sup>91</sup> *Ibid* 708.

<sup>92</sup> [1974] 1 Ch 269.

automatic resulting trusts. The first question must therefore be into which category any given case falls<sup>93</sup>

Each of the presumed resulting trusts<sup>94</sup> and automatic resulting trusts<sup>95</sup> have a well documented legal pedigree and statutory formalities do not affect the creation or operation.<sup>96</sup> Automatic resulting trusts arise where, inter alia, an express trust fails,<sup>97</sup> where there is a failure to set out the trust<sup>98</sup> or dispose of the whole of the beneficial interest<sup>99</sup> where property is conveyed on trust but the specific purpose of the trust fails<sup>100</sup> and where property conveyed on trust exceeds what is required.<sup>101</sup> Presumed resulting trusts arise where there has been a voluntary transfer of some forms of property<sup>102</sup> (although the law is not devoid of difficulties)<sup>103</sup> or a purchase money situation, where one party purchases property in the name of another.<sup>104</sup> The

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<sup>93</sup> Ibid 289.

<sup>94</sup> *Dyer v Dyer* (1788) 2 Cox 92; 30 ER 42; *Ingram v Ingram* [1941] VLR 95; *Jones v Parkinson* [1952] NZLR 89; *Bateman Television Ltd (in liq) v Bateman and Thomas* [1971] NZLR 453; *Napier v Public Trustee (WA)* (1980) 32 ALR 153; *Calverley v Green* (1984) 155 CLR 242; *Nelson v Nelson* (1995) 184 CLR 538.

<sup>95</sup> *Re Gillingham Bus Disaster Fund v Official Solicitor* [1959] Ch 62; *Re West Sussex Constabulary's Widows Children & Benevolent (1930) Fund Trusts* [1971] Ch 1; *Watson v Holland (Inspector of Taxes)* [1985] 1 All ER 290.

<sup>96</sup> See for example, *Conveyancing Act* 1919 (NSW) s 23C (2); *Property Law Act* 1958 (Vic) s 53(2); *Law of Property Act* 1925 (UK) s 53 (2).

<sup>97</sup> Ford and Lee, above n 22, [21030]; Meagher and Gummow above, n 22, [1205].

<sup>98</sup> Meagher and Gummow, above n 22, [1203].

<sup>99</sup> Ford and Lee above n 22, [21010]; Meagher and Gummow, above n 22, [1204].

<sup>100</sup> Meagher and Gummow, above n 22, [1206]; GE Dal Pont and DRC Chalmers, *Equity and Trusts in Australia and New Zealand* (1996), 416.

<sup>101</sup> *Re Trusts of the Abbott Fund; Smith v Abbott* [1900] 2 Ch 326; *Re British Red Cross Balkan Fund* [1914] 2 Ch 419; *Re Gillingham Bus Disaster Fund v Official Solicitor* [1959] Ch 62; Meagher and Gummow, above n 22, [1207]; Dal Pont and Chalmers, above n 99, 416.

<sup>102</sup> Ford and Lee, above n 22, [21080]-[21100].

<sup>103</sup> Meagher and Gummow, above n 22, [1220]-[1221].

<sup>104</sup> Ford and Lee above n 22, [21110]-[21120]; Meagher and Gummow, above n 22, [1210]-[1211]; *Napier v Public Trustee (WA)* (1980) 32 ALR 153; *Jones v Parkinson* [1952] NZLR 89; *Heneker v Heneker* [1954] SASR 181. In relation to personal property see *Russell v Scott* (1936) 55 CLR 440; *Bateman TV Ltd (in liq) v Bateman and Thomas* [1971] NZLR 453.

presumed resulting trust may be rebutted by evidence that the contributor of the purchase price intended to benefit the party in whose name the property or interest is registered<sup>105</sup> or by the presumption of advancement.<sup>106</sup> Whilst the continued existence of the presumption of advancement has been questioned,<sup>107</sup> it is still an operative principle.<sup>108</sup>

Whilst much has been written on the resulting trust, its impact in bankruptcy and insolvency situations has often gone unnoticed.<sup>109</sup> Yet a party which is entitled to claim an interest under a resulting trust

is like a beneficiary under an express trust in many respects.<sup>110</sup>

A beneficiary under a resulting trust will be able to claim that he has a proprietary interest which is effective against any claims of a trustee in bankruptcy. For example, in *Re 389179 Ontario Ltd; Re Peat Marwick Ltd*,<sup>111</sup> 389178 Ontario Ltd supplied funds for the purchase of assets of Barrie's Ltd as vendor. However, the assets which were purchased were taken in the name of another separate company, 389179 Ontario Ltd. A receiving order was made against 389179 Ontario Ltd and it was argued on behalf of 389178 Ontario Ltd that the assets were not part of the former company's asset base. This argument succeeded, notwithstanding the fact that both companies had common directors and shareholders.<sup>112</sup> The funds used to purchase the property had been borrowed from a third party<sup>113</sup> and the purchase transaction between the companies had been used to artificially inflate the value of the property

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<sup>105</sup> Ford and Lee, above n 22, [21130] and [21150]; Meagher and Gummow, above n 22, [1213].

<sup>106</sup> *Charles Marshall Pty Ltd v Grimsley* (1956) 95 CLR 353; *Nelson v Nelson* (1995) 184 CLR 538. For a comprehensive discussion of the presumption of advancement see Ford and Lee, above n 22, [21160]-[21170] and Meagher and Gummow, above n 22, [1212].

<sup>107</sup> See *Calverley v Green* (1984) 155 CLR 242, 265 (Murphy J); *Dulow v Dulow* (1985) 2 NSWLR 531, 535-536 (Hope JA).

<sup>108</sup> *Nelson v Nelson* (1995) 184 CLR 538, 602 (McHugh J).

<sup>109</sup> cf Robert Chambers, *The Resulting Trust* (1997).

<sup>110</sup> Ford and Lee, above n 22, [21180].

<sup>111</sup> (1980) 34 CBR (NS) 46.

<sup>112</sup> *Ibid* 47.

<sup>113</sup> *Ibid* 47-49.

in order to support the mortgages.<sup>114</sup> The facts disclosed that the presumption operated, *prima facie*, and there was no evidence to suggest that the presumption was rebuttable<sup>115</sup> or that the funds did represent a loan between the companies.<sup>116</sup> Thus, the presumed resulting trust was used with considerable effectiveness, (together with the separate legal identity doctrine),<sup>117</sup> to prove that the insolvent company did not have the beneficial or equitable interests in the disputed assets.<sup>118</sup> Therefore, whilst the resulting trust did not specifically arise in response to insolvency contexts, it is a powerful proprietary device.

Although the concept of risk assumption has not been posited as a rationale for the resulting trust, it is arguable that it is a better explanation than the absence of intention or presumed intention. The circumstances warrant the intervention of equity on the basis that it cannot be presumed that the supplier of a purchase fund or a settlor assumed the risk of the recipient's insolvency. Certainly, such an explanation provides a modern underpinning of the resulting trust which increasingly appears as an early precursor of the remedial constructive trust.<sup>119</sup>

### ***D Fiduciary Obligations, the Institutional Constructive Trust and Equitable Tracing***

Fiduciary obligations, which provide an even wider proprietary gateway, arise where there is a relationship of trust and confidence. It has been suggested that the earliest fiduciaries were trustees, administrators and bailees<sup>120</sup> and that other kinds of fiduciaries appeared much later in the 18th century.<sup>121</sup> However, the

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<sup>114</sup> Ibid 49.

<sup>115</sup> Ibid 52-55.

<sup>116</sup> Ibid.

<sup>117</sup> *Salomon v A Salomon & Co Ltd* [1897] AC 22; *Lee v Lee's Air Farming Ltd* [1961] AC 12; *Macaura v Northern Assurance Co Ltd* [1925] AC 619.

<sup>118</sup> See also *Howard Graff v Deloitte & Touche, as Trustee in Bankruptcy for the Estate of Trevor Richard Bitz* [1992] 2 WWR 162; *Re Heffner and Price Waterhouse Ltd* (1987) 32 DLR (4th) 760.

<sup>119</sup> See the discussion about the resulting trust and the constructive trust in Chapter 3, 122-127, 129-132.

<sup>120</sup> Tamar Frankel, 'Fiduciary Law' (1983) 71 *California Law Review* 795, 795.

<sup>121</sup> Ibid.

identification of fiduciary obligations appears to have been a much later phenomenon. Sealy has argued that the first identifiable formulation of fiduciary obligations occurred in the 18th century.<sup>122</sup>

During the 19th century the word 'trust' was used to describe relationships which a modern lawyer would consider as being essentially fiduciary.<sup>123</sup> Sealy has identified that the word 'trust' was used to describe not only cases where a party held property for and on behalf of another, but also where a party held no property but was simply in a position of trust and confidence.<sup>124</sup> What is essential in the fiduciary relationship is that one party has reposed trust and confidence in another.<sup>125</sup> Therefore, although a substantive trust relationship does not exist, one party stands in a position of trust in relation to the other although the expansion of fiduciary obligations in some jurisdictions and judicial discussion of the expansion strongly suggests that the trust analogy is no longer adequate.<sup>126</sup> A major difference between the trust and fiduciary obligations is that whereas a trustee is invariably entrusted with property,<sup>127</sup> fiduciary obligations may arise where the fiduciary does not hold property for and on behalf of the beneficiary.<sup>128</sup> Therefore, whilst a trust relationship is invariably fiduciary, fiduciary obligations do not necessarily entail the existence of trusts.<sup>129</sup>

However, where property is vested in the fiduciary and/or later proprietary interests arise, a fiduciary is generally called a trustee. Where the holding of property

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<sup>122</sup> LS Sealy, 'Fiduciary Relationships' [1962] *The Cambridge Law Journal* 69, 69-70.

<sup>123</sup> *Ibid*; *Cholmondeley and Damer v St John Clinton* (1821) 4 Bli 1; 4 ER 721.

<sup>124</sup> Sealy, above n 122, 71-72.

<sup>125</sup> John Glover, *Commercial Equity: Fiduciary Relationships* (1995) [1.12] and Patrick Parkinson, 'Fiduciary Obligations' in Patrick Parkinson (ed), *The Principles of Equity* (1996) 325, [1009]-[1011].

<sup>126</sup> See for example *Frame v Smith* [1987] 2 SCR 790; (1987) 42 DLR (4th) 81; *Hodgkinson v Simms* [1994] 3 SCR 377; (1995) 117 DLR (4th) 161.

<sup>127</sup> Meagher and Gummow, above n 22, [202]-[208], 5; see also Ford and Lee, above n 22, [1000].

<sup>128</sup> Meagher and Gummow, above n 22, [208]; Parkinson, above n 125, [1011]; *Reading v The King* [1949] 2 KB 232, 236 (Asquith LJ).

<sup>129</sup> Meagher and Gummow, above n 22, [202].

for another is involved, trust law and fiduciary obligations noticeably converge.<sup>130</sup> But, the ways in which the subsequent trust relationship arises will be different. Traditionally, there are essentially three situations where the fiduciary may be a trustee.

First, the fiduciary may receive property from the beneficiary as part of the relationship between the parties. The mere receipt of property does not necessarily give rise to a trust. There must be an intention that the legal title of the property vests with the fiduciary. There are many relationships where fiduciaries are entrusted with property to carry on a transaction or for the purpose of safekeeping<sup>131</sup> such as bailees,<sup>132</sup> brokers,<sup>133</sup> and agents,<sup>134</sup> but a trust does not automatically arise. The notion of vesting title in property in a bailor who has received physical possession is totally antithetical to the concept of bailment.<sup>135</sup> Agents or brokers do not hold the proceeds of sale of assets entrusted to them for the purposes of sale as trustees<sup>136</sup> unless the contracts between the parties provide so.<sup>137</sup> The different standards are explicable on the basis of the varying and divergent functions of fiduciaries. Moreover, in the case of agents and brokers in particular, commercial transacting would become unmanageable if funds transferred to them or received from the sale of assets were automatically subject to a trust. Here, money operates as a negotiable commodity. However, equity is becoming more flexible in the relief that it does grant. The decision in *Attorney-General (Hong Kong) v Reid*<sup>138</sup> may be effectively

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<sup>130</sup> PD Finn, *Fiduciary Obligations* (1977) [184].

<sup>131</sup> Glover, above n 125, [3.69]; Scott and Fratcher, above n 62, vol VA, § 530.

<sup>132</sup> *Kingsmill v Lyne* (1910) 13 CLR 292; *Everingham v Everingham* (1911) 12 SR (NSW) 5.

<sup>133</sup> *King v Hutton* (1900) 83 LT 68; *Re Goode; Ex parte Mount* (1974) 4 ALR 579; *Option Investments (Aust) Pty Ltd v Martin* (1980) 5 ACLR 124; *Daly v Sydney Stock Exchange Ltd* (1986) 160 CLR 371; Glover above n 125, [3.62]-[3.68].

<sup>134</sup> *Walker v Corboy* (1990) 19 NSWLR 382.

<sup>135</sup> *Davis v Heuber* (1923) 31 CLR 583, 595 (Higgins J).

<sup>136</sup> *Walker v Corboy* (1990) 19 NSWLR 382; *Re Goode; Ex parte Mount* (1974) 4 ALR 579; Glover, above n 125, [3.72]-[3.80].

<sup>137</sup> See for example *Stephens Travel Service International Pty Ltd (Receivers and Managers Appointed) v Qantas Airways Ltd* (1988) 13 NSWLR 331.

<sup>138</sup> [1994] 1 AC 324.



used in the future to impose proprietary relief against agents or bailors who make unauthorised profits or gains out of the relationship even where assets have not been transferred to them. However, in other cases such as the relationship of solicitor to client, safekeeping has been elevated to a trust relationship. Therefore, in *Re A Solicitor*<sup>139</sup> the funds in a solicitor's trust account for the benefit of a client did not vest in the trustee in bankruptcy.<sup>140</sup> The trust status which exists in relation to such property is so entrenched in principle that it has been enshrined in legislation.<sup>141</sup>

Secondly, if a fiduciary makes an unauthorised profit or gain out of the fiduciary relationship, he will become a trustee of the profit or the property which has been acquired from the profit. Here, the trust has influenced fiduciary obligations.<sup>142</sup> This approach to gains made from the fiduciary relationship has been generally applied strictly.<sup>143</sup> Even so-called honest or innocent profits or gains must be accounted for.<sup>144</sup> The enforcement of fiduciary obligations is subject to the personal remedy of account of profits.<sup>145</sup> However, from a proprietary perspective, fiduciaries are deemed to be constructive trustees of the gain which has been made from the use of trust property.<sup>146</sup> Fiduciaries have been held to have misused or misappropriated trust property or opportunity where one party renewed a lease for

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<sup>139</sup> (1952) 1 Ch 328.

<sup>140</sup> See also *Re Jones (Deceased): Ex parte Mayne* (1953) 16 ABC 169; *Re Stillman and Wilson* (1950) 15 ABC 68; *Re Estate of Lee* (1937) 9 ABC 196.

<sup>141</sup> In relation to solicitors note: *Legal Profession Act* 1987 (NSW) s 61; *Trust Accounts Act* 1973 (Qld) s 7 (1); *Legal Practitioners Act* 1981 (SA) s 31 (1); *Legal Practice Act* 1996 (Vic) ss 173 and 174; *Legal Profession Act* 1993 (Tas) s 101; *Legal Practitioners Act* 1893 (WA) s 34 (1); *Legal Practitioners Act* 1970 (ACT) s 91; *Legal Practitioners Act* 1974 (NT) s 57; *Law Practitioners Act* 1982 (NZ) s 89 (1). For a comprehensive discussion of solicitors duty to account see GE Dal Pont, *Lawyers' Professional Responsibility in Australia and New Zealand* (1996) Chapter 10.

<sup>142</sup> Parkinson, above n 125, [1010].

<sup>143</sup> *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378; [1967] 2 AC 134n; *Boardman v Phipps* [1967] 2 AC 46.

<sup>144</sup> *Boardman v Phipps* [1967] 2 AC 46.

<sup>145</sup> For a discussion of account of profits as a remedy see the decision of the High Court of Australia in *Warman International Ltd v Dwyer* (1995) 182 CLR 544, 556-562 (Mason CJ, Brennan, Deane, Dawson and Gaudron JJ).

<sup>146</sup> *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41, 107-110 (Mason J).

his benefit to the exclusion of the other<sup>147</sup> or where the fiduciary used money of the trust to purchase property in his name.<sup>148</sup> A fiduciary may also obtain profits or gains other than by use of trust property. Such a situation would be where the fiduciary uses his position as a fiduciary<sup>149</sup> or information gleaned during the course of the fiduciary relationship to obtain a profit.<sup>150</sup>

The constructive trust which arises in response to breach of fiduciary obligation is often referred to as an institutional constructive trust rather than a remedial constructive trust.<sup>151</sup> Generally, the former trust arises notwithstanding the intention of the parties,<sup>152</sup> but in other respects is considered to be akin to the express trust in the sense it arises where there is identifiable property, the legal title to which is vested in one party and the equitable title vested in the another.<sup>153</sup> Such a constructive trust has also been utilised against third parties who have knowingly received trust property as the result of a breach of trust or fiduciary obligation.<sup>154</sup> The institutional constructive trust operates like an express trust in insolvency situations. Therefore, property which is subject to a constructive trust does not form part of the insolvent's assets.

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<sup>147</sup> *Keech v Sandford* (1726) Sel Cas T King; 25 ER 223 and *Chan v Zacharia* (1984) 154 CLR 178.

<sup>148</sup> *Paul A Davies (Australia) Pty Ltd v Davies (No 2)* (1983) 1 NSWLR 440.

<sup>149</sup> *Attorney-General (Hong Kong) v Reid* [1994] 1 AC 324.

<sup>150</sup> See *Boardman v Phipps* [1967] 2 AC 46; *DPC Estates v Grey and Consul Development Pty Ltd* (1974) 1 NSWLR 443, 470-471 (Hutley JA); Justice BH McPherson, 'Information as Property in Equity' in Malcolm Cope (ed), *Equity: Trends and Issues* (1995) 234.

<sup>151</sup> M Cope, *Constructive Trusts* (1992) 12-15; DWM Waters, *The Constructive Trust: The Case for a New Approach in English Law* (1964) 9-19; Wright, above n 26, [2.2].

<sup>152</sup> Cope, above n 151, 9; Waters, above n 48, 12; Barbara McDonald, 'Constructive Trusts' in Patrick Parkinson (ed), *The Principles of Equity* (1996) 709, [2101]; cf Ford and Lee, above n 22, [22000].

<sup>153</sup> See for example RH Maudsley, 'Constructive Trusts' (1977) 28 *Northern Ireland Legal Quarterly* 123.

<sup>154</sup> *Barnes v Addy* (1874) LR 9 Ch App 244, 251-252 (Lord Selborne LC); Cases which discuss aspects of this rule include: *Stephens Travel Service International Pty Ltd (Receivers and Managers Appointed) v Qantas Airways Ltd* (1988) 13 NSWLR 331; *Consul Development Pty Ltd v DPC Estates Pty Ltd* (1975) 132 CLR 373; *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 378; *Lankshear v ANZ Banking Group (New Zealand) Ltd* [1993] 1 NZLR 481.

Thirdly, in addition to the constructive trust as outlined above, parties to whom fiduciary obligations are owed have the opportunity to access tracing rules.<sup>155</sup> McDonald has pointed out that whilst the institutional constructive trust and equity's tracing rules are not inconsistent, they are different. She has stated:

Tracing, being purely proprietary, persists against even an innocent volunteer but ceases once the property has been lost or dissipated. A constructive trust, relying not so much on the notion of property as on the culpability of the defendant, persists as a personal liability even when the property can no longer be traced or identified. The constructive trust, involving liability to compensate for losses and to account for gains will also be the more attractive remedy where either the property has depreciated in value or the claim is also for incidental profits made by the third party for use of the property.<sup>156</sup>

The difference between the institutional constructive trust and equity's tracing rules can be explained on the basis of their different historical origins.

The institutional constructive trust arose where the recipient of the property had notice of the breach of trust or fiduciary obligation. As early as the 16th century, the institutional constructive trust was being successfully imposed on errant trustees. Holdsworth has pointed out that the issue was whether there was sufficient notice of breach of trust where third parties were involved.<sup>157</sup> The concept of constructive notice was being considered.<sup>158</sup> Interestingly, the concept of notice still remains largely unresolved today in relation to some aspects of the institutional constructive trust and third party receipt of trust property.<sup>159</sup>

In contrast, the equitable rules of tracing have both more distant and more recent origins than the institutional constructive trust. Equitable tracing rules arose in

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<sup>155</sup> For helpful discussions concerning tracing see Meagher and Gummow, above n 22, Chapter 27; Ford and Lee, above n 22, [17190]-[17390]; Malcolm Cope, *Proprietary Claims and Remedies* (1997) Chapters 7-11.

<sup>156</sup> McDonald, above n 152, [2126]. See also *Re Montagu's Settlement Trusts* [1987] 1 Ch 264, 285 (Sir Robert Megarry VC).

<sup>157</sup> Holdsworth, above n 15, vol 5, 305-306.

<sup>158</sup> Ibid.

<sup>159</sup> McDonald, above n 152, [2129]-[2132], [2137]; Michael Evans, *Outline of Equity and Trusts*, (3<sup>rd</sup> ed, 1996) [17.36]-[17.39], [17.41]-[17.46]; Meagher and Gummow, above n 22, [1335].

response to the limitations which existed and still exist in common law following. Common law following rules were limited to conversion, detinue and money had and received.<sup>160</sup> Moreover, whilst property can be followed when it is no longer in the hands of the wrongdoer, it cannot be followed when it has been mixed with other property of a like nature so that it is no longer identifiable.<sup>161</sup> The common law is 'strictly materialistic.'<sup>162</sup> Thus, common law following is of limited assistance where money as a fungible is involved. Money may be both unidentifiable and non-physical.<sup>163</sup>

In comparison, equitable tracing permits not only tracing into the hands of third parties, but also tracing into a mixed fund.<sup>164</sup> The equitable tracing rules not only apply to money but to chattels, subject to the requirement that the chattels can be identified and separated from the mixed assets.<sup>165</sup> Equitable tracing rules appear to have more distant origins than common law following in the sense that it is likely that the development of equitable tracing was influenced by Roman law. Roman law developed the sophisticated rules *confusio* and *commixtio* to deal with the admixture of property. *Confusio* dealt with the mixture of liquids. When fluids were mixed, whether with or without the owners' consent, such owners became joint owners of the mixture.<sup>166</sup> *Commixtio* was concerned with the mixture of grains and like materials. If there had been consent to the mixture of the solids, then the parties had joint ownership.<sup>167</sup> When the parties had not consented to the admixture of their

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<sup>160</sup> Meagher and Gummow, above n 22, [2702].

<sup>161</sup> *Taylor v Plumer* (1815) 3 M & S 62; 105 ER 721; cf the views of Salman Khurshid and Paul Matthews, 'Tracing Confusion' (1979) 95 *The Law Quarterly Review* 78; LD Smith, 'Tracing in *Taylor v Plumer*; Equity in the Court of King's Bench' [1995] *Lloyd's Maritime and Commercial Law Quarterly* 240.

<sup>162</sup> *Re Diplock* [1948] Ch 465, 580 (Lord Greene MR).

<sup>163</sup> See Chapter 1, 10-11.

<sup>164</sup> *Re Hallett's Estate; Knatchbull v Hallett* (1880) 13 Ch D 696; *Brady v Stapleton* (1952) 88 CLR 322; Michael Christie, 'Tracing' in Patrick Parkinson (ed), *The Principles of Equity* (1996) 816, [2320]-[2333].

<sup>165</sup> See for example *Borden (UK) Ltd v Scottish Products Ltd* [1981] Ch 25.

<sup>166</sup> DH Van Zyl, *History and Principles of Roman Law* (1983) 158. For other discussions see RW Lee, *The Elements of Roman Law* (4<sup>th</sup> ed, 1956) 133-134 and Goff and Jones, above n 24, 76.

<sup>167</sup> *Ibid* 159.

separate assets, then individual ownership in relation to the assets continued to exist.<sup>168</sup> When it was impossible to identify and separate the property (such as in the case of mixed grain), Roman law entitled the owner to a share of the mixture. This concept was extended to money. Where there had been a mixture of coins which belonged to different owners, the party who possessed the coinage obtained title to the coinage. However, the other earlier owners of the coinage were entitled to claim the value of their original coinage and were not required to identify the original coins.<sup>169</sup> Therefore, it appears that Roman law retained the negotiability of money<sup>170</sup> and at the same time ensured that the rightful owner was entitled to claim the value of his original coinage.

*Re Hallett's Estate; Knatchbull v Hallett*<sup>171</sup> established a position which is not dissimilar from the approach of Roman law. The case stands specifically for several important propositions. Where a trustee mixes trust money with his own and purchases a property with that new fund, that beneficiary cannot claim the property as his own. However, the beneficiary is entitled to a charge (or more properly speaking, an equitable lien)<sup>172</sup> over the property for an amount equivalent to the trust funds expended on the purchase.<sup>173</sup> Where trust moneys are paid into a mixed fund and withdrawals are made, it is presumed that the trustee withdraws his own funds first, if there was never any stage at which the trust fund was utilised.<sup>174</sup> However, the case also paved the way for a proprietary interest in the form of a charge over the whole of a mixed fund or its substitute. Thus, a beneficiary, like his Roman legal forbears, is effectively entitled to an amount from the larger mixed fund equivalent to the money which belonged to him. He is not required to identify the money which belonged to him or be able to segregate that money. Instead, the errant fiduciary has legal title to the fund, but the beneficiary has a security interest over the mixed fund

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<sup>168</sup> Ibid.

<sup>169</sup> Ibid.

<sup>170</sup> See Chapter 1, 12-13.

<sup>171</sup> (1880) 13 Ch D 696.

<sup>172</sup> For a discussion of the equitable lien see Chapter 7, 293-297.

<sup>173</sup> (1880) 13 Ch D 696, 709 (Jessel MR).

<sup>174</sup> Ibid 727-728 (Jessel MR).

equivalent to the trust funds. Thus, simultaneously, the negotiability of money<sup>175</sup> is retained and the beneficiary acquires a security interest with proprietary consequences. Equity adopted 'a more metaphysical approach'.<sup>176</sup> Therefore, equity substantially (although not entirely) treated money as a fungible item in a way similar to the Roman law and also in a manner which the common law had treated other fungible items.<sup>177</sup> Equity's logical and plausible (but it is submitted uninspired) step has been long lasting.

Traditionally, equitable tracing has had two main limitations. Equitable tracing has been available only to parties owed fiduciary obligations in respect of the property entrusted to them.<sup>178</sup> This approach has been questioned and will be further considered in Chapter 3.

Equitable tracing rules are helpful so long as the trust property can be identified in its original form, in a mixed fund or in a substituted form.<sup>179</sup> Not only must the plaintiff identify the recipient of the funds, but also the destination of the moneys as well. Where, for example, a trustee simply mixes trust property with his own property, a beneficiary will be entitled to trace into such a fund.<sup>180</sup> So long as the mixed fund is ascertainable, a beneficiary may be entitled to a charge over the mixed fund for an amount equivalent to the amount in dispute.<sup>181</sup> However, where the funds have been completely or partially dissipated, the beneficiary faces difficulties.

Partial dissipation could occur where a trustee mixes his own funds with trust funds in a bank account. He withdraws an amount from the account which is greater

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<sup>175</sup> See Chapter 1, 12-13 for a discussion of this concept.

<sup>176</sup> *Re Diplock* [1948] Ch 465, 520 (Lord Green MR).

<sup>177</sup> Goff and Jones, above n 24, 76.

<sup>178</sup> *Sinclair v Brougham* [1914] AC 398; *Re Diplock* [1948] Ch 465, 520-521, 532, 540 (Lord Greene).

<sup>179</sup> McDonald, above n 152, [2126]. For an interesting example see *Re Delta Smelting & Refining Co* (1988) 72 CBR (NS) 295; 33 BCLR (2d) 383.

<sup>180</sup> *Re Hallett's Estate; Knatchbull v Hallett* (1888) 13 Ch D 696.

<sup>181</sup> For a helpful discussion of tracing into a mixed fund see Meagher and Gummow above n 22, [2709]-[2712]; Ford and Lee, above n 22, [17240]-[17280] and Christie, above n 164, [2320]-[2331].

than his own money in the account. The beneficiary is only entitled to the amount equal to that remaining in the account even if at a later stage the trustee makes further deposits. This is known as the intermediate balance rule.<sup>182</sup>

Complete dissipation of the trust moneys could occur when the trustee spends all the money on a holiday. Another example of an effective and complete dissipation of trust funds occurred in *Re Diplock*<sup>183</sup> where executors paid charitable institutions substantial moneys pursuant to an invalid bequest. The Court of Appeal held that the moneys spent by charities altering and improving buildings<sup>184</sup> and paying off unsecured debts<sup>185</sup> could not be traced because 'the money will have disappeared leaving no monetary trace behind.'<sup>186</sup> The decision has been criticised for failing to apply the tracing rules to their fullest extent<sup>187</sup> and for applying an emasculated version of the restitutionary defence of change of position.<sup>188</sup> The decision could be explained on the basis that if the tracing rules were allowed to operate, an innocent volunteer would be forced to sell the improved property in order to fulfil the charge which the next of kin sought to have imposed. For our purpose, however, the significance of the decision in *Re Diplock* is that an equitable proprietary interest may be dissipated although the assets into which the moneys have been paid remain in existence and are clearly identifiable. Therefore, despite equity's willingness to allow tracing into mixed funds, its tracing rules do not provide a basis for relief in all cases.

Whilst the rules may appear mechanical and unprincipled,<sup>189</sup> the perfunctory application of them betrays the reality that there must exist a direct link to specific

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<sup>182</sup> *James Roscoe (Bolton) Ltd v Winder* [1915] 1 Ch 62; *Lofts v McDonald* (1974) 3 ALR 404; *Re Goldcorp Exchange Ltd (In Receivership)* [1995] 1 AC 74; *Bishopsgate Investment Management Ltd (in liquidation) v Homan* [1995] Ch 211.

<sup>183</sup> *Re Diplock* [1948] Ch 465.

<sup>184</sup> *Ibid* 547.

<sup>185</sup> *Ibid* 549.

<sup>186</sup> *Ibid* 547.

<sup>187</sup> Graham Moffat, *Trust Law: Texts and Materials* (2<sup>nd</sup> ed, 1994) 429.

<sup>188</sup> Lord Goff of Chieveley and Gareth Jones, *The Law of Restitution* (3<sup>rd</sup> ed, 1986), 76. But now see Goff and Jones, above n 24, 90-92.

<sup>189</sup> Dale A Oesterle, 'Deficiencies of the Restitutionary Right to Trace Misappropriated Property in Equity and in UCC § 9-306' [1983] 68 *Cornell Law Review* 172; Christie, above n 164, [2305]; cf

moneys (even though they are mixed with other moneys) before equitable tracing rules will operate. Again, the thrust of tracing in equity is apparently similar to Roman law in the sense that *commixtio* and *confusio* applied to the mixed fungibles where there was an unbroken connection between the disputed assets and the mixed mass.<sup>190</sup>

Despite the fact that the institutional constructive trust and equitable tracing each have different historical origins, they operate in a surprisingly synchronistic way. Where the property, which is the subject of the institutional constructive trust, has been dissipated and can no longer be traced, the beneficiary still has access to an in personam remedy against the constructive trustee. So too, where tracing is being utilised and the property is dissipated, the equitable tracing trail may come to an end, but the beneficiary is still entitled to an in personam remedy against the errant trustee or fiduciary.<sup>191</sup> Another aspect of the synchronicity is that the institutional constructive trust has been available as an alternative to a charge, particularly where specific restitution of an asset is required.<sup>192</sup> It also appears that a beneficiary under an institutional constructive trust can utilise equity's tracing rules.<sup>193</sup>

Notwithstanding the proprietary limitations of the institutional constructive trust and equitable tracing, they remain powerful proprietary gateways in insolvency contexts. Institutional constructive trusts operate like express trusts to ensure that funds or assets do not form part of the insolvent's estate. So too, the institutional constructive trust or the equitable lien (which may result from the successful operation of the equitable tracing rules) may respectively, remove assets or secure assets, so that the unsecured creditor has a proprietary and priority interest.<sup>194</sup>

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Greg Reinhardt, 'The Availability of Tracing to the Insolvency Administrator – Is the Remedy Adequate?' (1996) 4 *Insolvency Law Journal* 74, 84. In relation to tracing the proceeds of crime see Helen Norman, 'Tracing the Proceeds of Crime: an Inequitable Solution?' in Peter Birks (ed), *Laundering and Tracing* (1995) 95.

<sup>190</sup> Goff and Jones, above n 24, 76.

<sup>191</sup> Useful discussions are Dal Pont and Chalmers, above n, 100, 529-537; Ford and Lee, above n 22, [17110]-[17170]; Waters, above n 48, Chapter 25.

<sup>192</sup> Christie, above n 164, [2308] and [2310].

<sup>193</sup> *Canadian Pacific Air Lines Ltd v Canadian Imperial Bank of Commerce* (1988) 61 OR (2d) 233.

<sup>194</sup> For further discussions concerning the equitable lien see below, 73-75; Chapter 7, 293-297.



The original underlying rationale for the institutional constructive trust and equitable tracing rules was the rectification of breach of trust and fiduciary obligations. Thus, it could be said that the institutional constructive trust and equitable tracing rectified what was essentially unconscionable conduct.

An interesting issue is whether fiduciary obligations, the institutional constructive trust and equitable tracing rules are explicable on the basis that the fiduciary did not assume the risks associated with the transaction. It cannot be simply stated that parties who transact with fiduciaries do not assume the commercial risk of the transaction (including the potential insolvency of the fiduciary). There are a number of decisions involving agents and brokers where the party to whom fiduciary duties were owed, were not entitled to proprietary relief because there was no reason to suggest that the unsecured creditors had not assumed the risk of the possible insolvency of the other party.<sup>195</sup> However, what can be said is that it has been held that where it is evident that a party reposed trust and confidence, to the extent that he or she did not assume the miscarriage of the commercial transaction and the concomitant insolvency of the other party, the recognition of fiduciary obligations may be appropriate.

In *Australian Securities Commission v Melbourne Asset Management Pty Ltd (Receivers and Managers Appointed)*,<sup>196</sup> Melbourne Asset Management ('MAM') and McKinley Wilson Nominees Pty Ltd ('Nominees') received moneys from the public which were to be on-lent on the security of first mortgages. The moneys were to be allocated to particular borrowers and first mortgages.<sup>197</sup> Neither separate trust funds nor a common trust fund pursuant to a single trust deed were set up.<sup>198</sup> Instead, the investment funds were mixed with the mortgage repayments and MAM's own funds. MAM became insolvent. Northrop J held:

From all the evidence, there can be no doubt that a fiduciary relationship existed between MAM and each investor. This relationship arose from the nature of the dealings between MAM and each investor. Neither company claimed any beneficial interest in the

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<sup>195</sup> See for example *Walker v Corboy* (1990) 19 NSWLR 382; *Re Goode; Ex parte Mount* (1974) 4 ALR 579.

<sup>196</sup> (1994) 49 FCR 334.

<sup>197</sup> *Ibid* 337.

<sup>198</sup> *Ibid* 354-356.

moneys advanced by the investors. MAM received the moneys on the basis that it would deal with the moneys in accordance with the investment scheme. In fact, it did not do so, but that does not alter the fiduciary relationship that existed between MAM and the investors.<sup>199</sup>

There were two interrelated reasons why the investors did not assume the risk of the insolvency of MAM and the recognition of a fiduciary relationship was warranted. First, the investors were entitled to rely on the honesty and integrity of the company to follow and administer the scheme. If this had been undertaken, then the investment funds would not have been mingled with MAM's general assets. Secondly, the investment scheme prescribed that the moneys would be allocated to a particular borrower and secured by a particular security. Therefore, the investors sought a secured status, albeit as against a third party borrower rather than MAM itself.<sup>200</sup> The fact that MAM failed to administer the scheme properly meant that the investors were unsecured creditors.

The decision in *MAM* also relates to a broader trend in fiduciary obligations. Where the fiduciary has acted wrongly in relation to assets transferred or received or has made an unauthorised profit or gain out of the relationship, then proprietary relief may be available. Certainly, *Attorney General (Hong Kong) v Reid*<sup>201</sup> indicates that parties to whom fiduciary obligations are owed, are not taken to have assumed the risk of the subsequent insolvency in the light of the wrongdoing.<sup>202</sup>

If trusts (and by association some fiduciary obligations) can be explained as situations where beneficiaries (who would otherwise be unsecured creditors) do not assume the risk of wrongdoing (and the insolvency of the fiduciary), then such traditional remedies as the institutional constructive trust and equitable tracing are indirectly informed by non-assumption of risk. It is a derivative or indirect factor. It is this reason (as well as the unconscionable conduct of a trustee or fiduciary) which sustains the proprietary intervention of equity. Otherwise, both the unconscionable conduct of the defendant and the beneficiary's legitimate non-assumption of risk

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<sup>199</sup> Ibid 358.

<sup>200</sup> See also *Liggett v Kensington* [1993] 1 NZLR 257, 270-271 (Cooke P).

<sup>201</sup> [1994] 1 AC 324.

<sup>202</sup> Ibid 331-332.

would remain substantially unredressed. However, mere insolvency will not amount to wrongdoing or unconscionable conduct.

## V SITUATIONS OTHER THAN TRUSTS AND FIDUCIARY OBLIGATIONS

There are a series of disparate relationships and factual contexts where traditionally, equity has been willing to intervene in order to protect one or both of the interests of the parties even though the parties were in an essentially commercial relationship. These contexts have given rise to various proprietary mechanisms and doctrines which have a proprietary effect.

### *A The Equitable Lien*

First, the equitable lien, as a form of equitable proprietary relief, is an effective security against insolvency. It will be recalled that in *Re Hallett's Estate*,<sup>203</sup> Jessel MR used the equitable charge as an effective security device to enforce equity's tracing rules. Strictly speaking, what Jessel MR was referring to was an equitable lien. Equitable charges arise by virtue of the intention of parties, whilst equitable liens arise by operation of law.<sup>204</sup> Thus, the equitable lien is allied to the resulting trust and the institutional constructive trust. An equitable lien in relation to land has been described as follows:

a pure hypothecation; it involves no transfer of actual or potential ownership, it does not depend on possession and it rests only on equity, with the result that it is unenforceable against the bona fide purchaser for value without notice of the legal estate...it is of a proprietary character.<sup>205</sup>

The lien differs from the trust in that the lien bestows security over property<sup>206</sup> rather than vests a party with an equitable proprietary interest.<sup>207</sup> The equitable lien, as a security device is also considered in Chapter 7.

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<sup>203</sup> (1880) 13 Ch D 696.

<sup>204</sup> Sykes and Walker, above n 1, 199

<sup>205</sup> Ibid.

<sup>206</sup> Ibid.

<sup>207</sup> Chapter 7, 291-293.

Common uses of the equitable lien (outside the tracing context) arise where equity intervenes to protect what is perceived as the legitimate interests of specific commercial parties. Thus a vendor may claim a lien over land which has been conveyed prior to being paid by the purchaser.<sup>208</sup> A purchaser may claim a lien over a vendor's land for an amount equivalent to the deposit or purchase price (as the case may be), when the purchaser has lawfully repudiated the contract.<sup>209</sup> A trustee has an equitable lien on trust property in respect of money properly expended in the due performance of trustee obligations.<sup>210</sup> On the dissolution of partnership by retirement, death or bankruptcy of a partner, the remaining partners or their representatives have a lien on all assets belonging to the partnership for the purpose of satisfying all claims against the partnership.<sup>211</sup> Thus, in *Re Wilson; Ex parte Robertson*<sup>212</sup> it was held that the solvent partner's lien over the partnership assets took priority over the claims of the insolvent partner's official assignee in bankruptcy. A person who has spent money on property in the mistaken belief that he has an interest in that property<sup>213</sup> or that he will acquire an interest in that property,<sup>214</sup> is entitled to a lien over the property provided that it is shown that the owner of the land stood by with knowledge of the expenditure. Finally, an insurer

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<sup>208</sup> See for example *Hearle v Botelers* (1604) Cary 25; 21 ER 14; *Chapman v Tanner* (1684) 1 Vern 267; 23 ER 461; *Mackreth v Symmons* (1808) 15 Ves Jun 329; 2 Ves Jun Supp 410; 33 ER 778; 34 ER 1155; *Lysaght v Edwards* (1876) 2 Ch D 499; *Kettlewell v Watson* (1884) 26 Ch D 501; *Re Birmingham, Savage v Stannard* [1959] Ch 523. For a discussion of vendors' liens see JHG Sunnucks 'Liens' in Lord Hailsham of St Marylebone (ed), *Halsbury's Laws of England*, (4<sup>th</sup> ed, 1979) vol 28 [555]-[559].

<sup>209</sup> See for example *Burgess v Wheate, Attorney-General v Wheate* (1759) 1 Eden 177; 28 ER 652; *Wythes v Lee* (1855) 3 Drewry 396; 61 ER 954; *Westmacott v Robins* (1862) 4 De GF & J 390; 45 ER 1234; *Rose v Watson* (1864) 10 HL Cas 672; *Whitbread & Co Ltd v Watt* [1902] 1 Ch 835 and Sunnucks, above n 208, [560]-[565].

<sup>210</sup> *Stott v Milne* (1884) 25 Ch D 710; *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360; *Re Enhill Pty Ltd* [1983] 1 VR 561; *Mansard Developments Pty Ltd v Tilley Consultants Pty Ltd* [1982] WAR 161.

<sup>211</sup> *West v Skip* (1749) 1 Ves Sen 239; 27 ER 1006.

<sup>212</sup> (1891) 1 BC (NSW) 61.

<sup>213</sup> *Ramsden v Dyson* (1866) LR 1 HL 129; *Neesom v Clarkson* (1845) 4 Hare 97; 67 ER 576; *Middleton v Magnay* (1864) 2 H & M 233; 71 ER 452; *Wilmott v Barber* (1880) 15 Ch D 96.

<sup>214</sup> *Cadorange Pty Ltd (in liq) v Tanga Holdings Pty Ltd* (1990) 20 NSWLR 26.

has a lien over any compensation the insured receives after the insurer has paid out its liabilities under the insurance policy.<sup>215</sup>

## ***B Equitable Assignments***

An equitable assignment of legal property or an equitable assignment of equitable property is a powerful proprietary device in insolvency situations. Such an assignment of property withdraws the equitable or beneficial interest from the insolvent's asset base. There are three situations which are relevant here. First, where property assignable at law is not effectively assigned, equity may intervene where the assignor has shown an irrevocable intention to assign.<sup>216</sup> Equity will recognise that the property has been validly transferred to another. Therefore, the property falls outside the insolvent's general assets which vest in the insolvency administrator and which are available for distribution to creditors.<sup>217</sup> However, in the case of insolvency of the assignor, such an assignment would be, *prima facie*, void for lack of consideration.<sup>218</sup>

Secondly, where an assignment for value fails at law, equity will effect an assignment.<sup>219</sup> In such a case, the legal owner has been considered to be a constructive trustee<sup>220</sup> of a limited or qualified kind.<sup>221</sup> Such an assignment would be

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<sup>215</sup> *Lord Napier and Ettrick v Hunter* [1993] AC 713.

<sup>216</sup> *Corin v Patton* (1990) 169 CLR 540.

<sup>217</sup> See for example *Re Rose; Midland Bank Executor and Trustee Company Ltd v Rose* [1949] Ch 78; *Re Rose; Rose v Inland Revenue Commissioners* [1952] 1 Ch 499; Cope, above n 151, Chapter 27.

<sup>218</sup> See *Bankruptcy Act 1966* (Cth) ss 120 and 121.

<sup>219</sup> *Holroyd v Marshall* (1862) 10 HLC 191; 11 ER 999; *Tailby v Official Receiver* (1888) 13 App Cas 523; *Federal Commissioner of Taxation v Petro Harrison Constructions Pty Ltd* (1987) 20 ALR 647. For helpful discussions see Meagher, Gummow and Lehane, above n 58, [609]-[613] and Diane Skapinker, 'Equitable Assignments' in Patrick Parkinson (ed), *The Principles of Equity* (1996) [1310].

<sup>220</sup> *Lysaght v Edwards* (1876) 2 Ch D 499, 507 (Jessel MR); *Shaw v Foster* (1872) LR 5 HL 321, 338 (Lord Cairns); Skapinker, above n 219, [1310]. However, note the discussion on equitable liens in Chapter 7, 310-311.

<sup>221</sup> *Raynor v Preston* (1881) 18 Ch D 1, 6 (Cotton LJ).

void if there was no consideration, the consideration was inadequate<sup>222</sup> or there was an intent to defraud creditors (notwithstanding the existence of valuable consideration).<sup>223</sup> However, the right to set aside such a transfer will be subject to the rights of an assignee who gave valuable consideration and who was unaware of the assignor's fraudulent act.<sup>224</sup>

Thirdly, in the 19th century, courts exercising equitable jurisdiction recognised that equity would intervene to give effect to an agreement to assign future property or a mere expectancy.<sup>225</sup> The principle in modern form is summarised by Meagher, Gummow and Lehane as follows:

Where:

- (a) A for valuable consideration agrees to assign, or purports presently to assign, an expectancy, of future property, to B,
- (b) the consideration has been paid, or executed, and
- (c) A acquires property which falls within the description of that which he agreed, or purported presently, to assign,

then in equity that property vests in B as soon as it is acquired by A and can be identified, without any further assurance by A and without any action by B. It is an example of equity regarding as done that which ought to be done.<sup>226</sup>

Therefore, if the vendor agrees to assign or assigns the future assets, once these assets (including book debts) come into his hands, the purchaser acquires a beneficial interest in the assets analogous to the status of a beneficiary under a trust.<sup>227</sup> Such an

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<sup>222</sup> *Bankruptcy Act 1966* (Cth) s 120 (1) (b).

<sup>223</sup> *Bankruptcy Act 1966* (Cth) s 121; For a discussion of the issue see McQuade and Gronow, above n 68, [121.1.05].

<sup>224</sup> *Ibid*; See also *Kevan v Crawford* (1877) 6 Ch D 29; *Re Johnson*; *Golden v Gillam* (1881) 20 Ch D 389; *Re Reis*; *Ex parte Clough* [1904] 2 KB 769.

<sup>225</sup> *Holroyd v Marshall* (1862) 10 HLC 191; 11 ER 999; *Tailby v Official Receiver* (1888) 13 App Cas 523.

<sup>226</sup> Meagher, Gummow and Lehane, above n 58, [652].

<sup>227</sup> *Collyer v Isaacs* (1881) 19 Ch D 342; *Tailby v Official Receiver* (1888) 13 App Cas 523; *Re Williams, Richards v Williams* [1930] 2 Ch 378; *Independent Automatic Sales Ltd v Knowles and Foster* [1962] 1 WLR 974; *Elders Pastoral Ltd v Bank of New Zealand (No 2)* [1990] 1 WLR 1478;

interest is not limited and operates where the assignor becomes insolvent and/or obtains a discharge before he acquires the property.<sup>228</sup> However, presumably, where there was an intent to defraud creditors, the assignor would not be able to rely on the principle. In addition, it has been suggested that if the contractual liability is proved and then the insolvent is discharged, the assignment has no further effect.<sup>229</sup> It has also been suggested that equitable principles should apply to the sale of future goods where sale of goods legislation applies.<sup>230</sup> However, there are several constraints on the operation of the doctrine. It is limited to a present assignment of future property. It applies only to future property which fits the description and then comes into existence. Consideration must be given before the doctrine will operate.<sup>231</sup>

### *C Accessorial Devices*

Equity has enabled and continues to enable parties to access the pre-existing securities or liens in favour of other parties in limited but important circumstances. The tools under which this has been achieved have been subrogation<sup>232</sup> and marshalling.<sup>233</sup>

#### **1 Subrogation**

It has been stated that:

Subrogation is a doctrine by which rights are transferred from one person to another by operation of law. Subrogation functions

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*Palette Shoes Pty Ltd v Krohn* (1937) 58 CLR 1, 27; *Akron Tyre Co Pty Ltd v Kittson* (1951) 82 CLR 477.

<sup>228</sup> *Re Lind, Industrial Finance Syndicate Ltd v Lind* [1915] 2 Ch 345; *Re Dent Ex parte Trustee* [1923] 1 Ch 113, 120 (P O Lawrence J).

<sup>229</sup> Meagher, Gummow and Lehane, above n 58, [656].

<sup>230</sup> *Ibid* [670].

<sup>231</sup> *Ibid* [652].

<sup>232</sup> For a comprehensive discussion of subrogation see Charles Mitchell, *The Law of Subrogation* (1994).

<sup>233</sup> For a comprehensive review of the law of marshalling see Meagher, Gummow and Lehane, above n 58, Chapter 11 and *Commonwealth Trading Bank of Australia v Colonial Mutual Life Assurance Society Ltd* [1970] Tas SR 120.

procedurally to avoid inconvenient circularities in litigation. Unnecessary steps are circumvented by third persons being compelled to allow their names to be used in proceedings between others. In both substantive and procedural uses, it can be said that the applicant 'stands in the shoes' of the person from whom subrogation is sought. The purpose is to avoid undesirable outcomes and procedural inconvenience. Subrogation gives effect to a broad sense of unconscionability where it regulates outcomes. Liabilities for debts and the commission of wrongs are brought home to persons ultimately responsible. Double compensation is denied to the victims of wrongs.<sup>234</sup>

The subrogation mechanism operates as a form of involuntary assignment.<sup>235</sup> This may well mean that the subrogated party is simply entitled to bring an action for personal relief.<sup>236</sup> However, it is possible that the party will be subrogated to assets or a security interest with dramatic results in an insolvency context. There are three vivid applications of subrogation doctrine in this regard.

First, the concept of subrogation has been effectively used where trusts, particularly trading trusts,<sup>237</sup> have operated. Trading trusts may be undercapitalised trading entities and creditors of the trading trust may be unable to recover what is due to them from the assets of the trading trust. However, creditors of trustees have been subrogated to any right of indemnity which the trustee has against the trust assets so long as the trustee has acted properly and in accordance with the terms of

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<sup>234</sup> John Glover, 'Subrogation' in Patrick Parkinson (ed), *The Principles of Equity* (1996) 549, [1501].

<sup>235</sup> Ibid [1502]; Meagher and Gummow, above n 22, [904]; JP Dawson, 'Restitution or Damages?' (1959) 20 *Ohio State Law Journal* 175, 183.

<sup>236</sup> See for example, *Castellain v Preston* (1883) 11 QBD 380.

<sup>237</sup> For a description of trading trusts see HAJ Ford and IJ Hardingham, 'Trading Trusts: Rights and Liabilities of Beneficiaries' in PD Finn (ed), *Equity and Commercial Relationships* (1987) 48; Meagher and Gummow, above n 22, [319].



the trust.<sup>238</sup> Most authorities effectively establish that only trust creditors are entitled to be subrogated against the trust assets.<sup>239</sup>

Secondly, where a lender makes an unsecured loan, the funds from which are used to pay out an unsecured creditor, the lender may be entitled to be subrogated to the security interest of the previous creditor. It has been suggested that there is a rebuttable presumption that the security remains effective for the benefit of the new creditor<sup>240</sup> and the defendant bears the burden of rebutting the presumption.<sup>241</sup> However, it remains unclear whether subrogation is only available where the parties actually intended that the new creditor access the pre-existing security as security for the loan,<sup>242</sup> where the lender or payer intended subrogation to the security<sup>243</sup> or where the new lender is subrogated to the pre-existing security interest unless a contrary intention is shown. It appears from Lord Diplock's statement in *Orakpo v Manson Investments Ltd*<sup>244</sup> that the last interpretation is more likely to be the appropriate approach.

Thirdly, there is the concept of lien by subrogation.<sup>245</sup> The concept of lien by subrogation applies where moneys are advanced at the request of trustees and where money is advanced to a prospective purchaser to pay the contract price.<sup>246</sup> The

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<sup>238</sup> *Re Exhall Coal Company Ltd*; *Re Bleckley* (1866) 35 Beav; 55 ER 970; *Re Johnson*; *Shearman v Johnson* (1880) 15 Ch D 548; *Re Holden* (1887) 20 QBD 43; *Re Pain* [1919] 1 Ch 38; *Re Staff Benefits Pty Ltd and the Companies Act* [1979] 1 NSWLR 207, 213 (Needham J); *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360, 371 (Stephen, Mason, Aickin and Wilson JJ).

<sup>239</sup> *Official Assignee v Jarvis* [1923] NZLR 1009; *Re Byrne Australia Pty Ltd and the Companies Act* [1981] 1 NSWLR 394; *Re Suco Gold Pty Ltd (in liq)* (1983) 33 SASR 99; cf *Re Enhill Pty Ltd* [1983] 1 VR 561.

<sup>240</sup> *Ghana Commercial Bank v DT Chandiram* [1960] AC 732.

<sup>241</sup> Glover, above n 234, [1513] citing *State Bank of New South Wales v Geeport Developments Pty Ltd* (1991) 5 BPR 11-947, 11,950-4 (Cohen J).

<sup>242</sup> *Evandale Estates Pty Ltd v Keck* [1963] VR 647, 652 (Hudson J).

<sup>243</sup> See *Boscawen v Bajwa* [1996] 1 WLR 328. Note also Wright, above n 26, [3.53].

<sup>244</sup> (1978) AC 95, 104-105; see also *State Bank of South Australia v Rothschild Australia Ltd* (1990) 8 ACLC 925, 940-943.

<sup>245</sup> Sunnucks, above n 208, [570].

<sup>246</sup> *Ibid.*

lender is entitled to subrogation to the vendor's lien (which would have existed if the vendor had remained unpaid) once the vendor has been paid.<sup>247</sup>

## 2 Marshalling

Marshalling entitles a party to access securities and interests. It operates where

in respect of two funds in the hands of one person, there is a double claimant (A) who can claim against both funds and a single claimant (B) who can claim against only one of the funds. The fund against which both A and B may claim is described henceforth as 'the double fund'; the fund against which only A may claim is described as 'the single fund'. If A chooses to satisfy her or his claim out of the double fund, B has a right to stand in A's place in respect of the single fund, to the extent that the double fund would have satisfied B's claim if A had not claimed upon it first. Thus, marshalling is closely allied to the doctrine of subrogation.<sup>248</sup>

It operates against the common debtor rather than against the double claimant. Whilst the double claimant is free to take action against any security in order to satisfy his or her claim, the single claimant should not be disadvantaged nor the common debtor advantaged. The law will not permit what would otherwise be an unjust outcome from the perspective of the single claimant.<sup>249</sup> In order for the doctrine of marshalling to operate, there must be a common debtor,<sup>250</sup> the alternative fund or security must be in existence<sup>251</sup> and the double claimant must have free and equal recourse to the same type of rights against each fund or security.<sup>252</sup> However,

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<sup>247</sup> Ibid.

<sup>248</sup> Barbara McDonald, 'Marshalling' in Patrick Parkinson (ed), *The Principles of Equity* (1996) 462, [1601].

<sup>249</sup> Ibid [1602]; *Chase Corp (Australia) Pty Ltd v North Sydney Brick & Tile Co Ltd* (1994) 35 NSWLR 1,19- 21 (Cohen J).

<sup>250</sup> *Ex parte Kendall* (1811) 17 Ves Jun 514; 2 Ves Jun Supp 496; 34 ER 199; 34 ER 1196; McDonald, above n 248, [1605]; Meagher and Gummow, above n 22, [1108].

<sup>251</sup> *Commonwealth Trading Bank v Colonial Mutual Life Assurance Society Ltd* [1970] Tas SR 120; McDonald, above n 248, [1606].

<sup>252</sup> *Webb v Smith* (1885) 30 Ch D 192; *Miles v Official Receiver in Bankruptcy* (1963) 109 CLR 501; McDonald, above n 248, [1607]-[1608]; Meagher and Gummow, above n 22, [1111].

the doctrine is essentially accessorial, it does not confer proprietary rights on the single claimant.<sup>253</sup>

The doctrine of marshalling has been pleaded where the common debtor has become insolvent.<sup>254</sup> A simple example illustrates its effectiveness. The common debtor borrows funds from A and provides two mortgages in favour of A over Properties X and Y respectively. The common debtor borrows funds from B and provides a mortgage over Property X in favour of B. The common debtor defaults under the loan made with A. A decides to exercise its power of sale against X. There are good reasons for A doing so. For example, whilst there has been a general downturn in demand for properties, Property X is located in one of the few areas where demand has remained high and A considers that it will be successful in selling the property in a relatively short time. A, as first mortgagee, sells the property but realises an amount sufficient to cover the common debtor's liabilities to it. In the meantime, the common debtor has become insolvent. Without the doctrine of marshalling, B would be characterised as an unsecured creditor. The mortgage over Property X which secured the loan from B, is no longer effective in the sense that Property X is no longer owned by the common mortgagor. Property X was sold to a bona fide purchaser for value pursuant to a valid mortgage by a mortgagee exercising power of sale. The only alternative is to permit B to be subrogated to A's remaining security, Property Y. In this way, B may not become a secured creditor again, but it has access to a pre-existing security and therefore stands ahead and apart from other unsecured creditors.

### ***D Proprietary Effect of the Additional Mechanisms and Doctrines***

An effective equitable assignment of future property assigns or vests the equitable interest of the property in the assignee. The assignor is effectively a trustee and s116 (2) (a) *Bankruptcy Act 1966* (Cth) would operate subject to voidable preference provisions.<sup>255</sup>

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<sup>253</sup> *Commonwealth Trading Bank v Colonial Mutual Life Assurance Society Ltd* [1970] Tas SR 120, 125-128 (Neasey J); Meagher, Gummow and Lehane, above n 58, [1105]; and *Sarge Pty Ltd v Cazihaven Pty Ltd* (1994) 34 NSWLR 658, 664-665 (Cohen J).

<sup>254</sup> See for example *Miles v Official Receiver in Bankruptcy* (1963) 109 CLR 501. *Sarge Pty Ltd v Cazihaven Homes Pty Ltd* (1994) 34 NSWLR 658.

<sup>255</sup> See *Bankruptcy Act 1966* (Cth) ss 120 and 121.

The security nature of the lien and the accessorial security effect of subrogation and marshalling is recognised under s 5 of the *Bankruptcy Act 1966* (Cth) which states that a 'secured creditor'

in relation to a debtor, means a person holding a mortgage, charge or lien on property of the debtor as a security for a debt due to him or her from the debtor.<sup>256</sup>

The definition is a wide one and includes any creditor

who is in a position, either at law or in equity, to obtain recoupment partly or wholly from the assets of the debtor in priority to unsecured creditors.<sup>257</sup>

Secured creditors stand ahead and apart from unsecured creditors because they have a direct claim on the assets of the debtor.<sup>258</sup> They are not subject to the ordinary rules governing insolvency and have a variety of options under which they can realise their interests under the security.<sup>259</sup>

### ***E The Historical and Doctrinal Bases***

It would be foolhardy to attempt to explain the additional situations by reference to one single doctrinal basis. Indeed, the specific doctrinal basis for each of the areas of additional cases could be disputed. For example, the doctrinal and historical basis of subrogation remains somewhat unclear and the subject of continuous debate.<sup>260</sup> However, it is submitted that there are some central common threads which should be raised at this stage.

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<sup>256</sup> Note also *Insolvency Act 1986* (UK) s 248; *Bankruptcy and Insolvency Act* RSC 1985 c B-3 s 2; *Re Commercial Textiles Ltd* (1940) 21 CBR 387.

<sup>257</sup> Dennis Rose, *Lewis: Australian Bankruptcy Law*, (10<sup>th</sup> ed, 1994), 108 and the various interests which Rose cites. In relation to corporations see HAJ Ford, RP Austin and IM, Ramsay, *Ford's Principles of Corporations Law* (8th ed, Butterworths, Sydney, 1997) [1.340].

<sup>258</sup> *Ibid* 107.

<sup>259</sup> *Bankruptcy Act 1966* (Cth) s 90; *Corporations Law* s 554E.

<sup>260</sup> *Memphis and Little Rock Railroad v Dow* (1887) 120 US 287, 302 (Harlan J); *Yonge v Reynell* (1852) 9 Hare 809, 818-819; 68 ER 744, 748-749 (Turner VC); *Lord Napier and Ettrick v Hunter* [1993] AC 713, 736-738 (Lord Templeman); *Orakpo v Manson Investments Ltd* [1978] AC 95, 104 (Lord Diplock); Goff and Jones, above n 24, 93 and 590; Mitchell, above n 232, 8-15.

First, it must be appreciated that equity developed the various additional situations as a reaction to different requirements during various historical periods. However, it appears that both the equitable lien<sup>261</sup> and marshalling<sup>262</sup> and even a form of equitable assignment had begun to emerge during equity's formative period.<sup>263</sup> Marshalling was a fully operative principle both in England and the United States during the 19th century.<sup>264</sup> By the end of the 19th century subrogation was an accepted equitable doctrine in the commercial sphere.<sup>265</sup>

Secondly, Roman law was a fertile precedent for equitable liens<sup>266</sup> and apparently French law for subrogation,<sup>267</sup> without any concern that these new equitable principles were used to intervene in commercial relationships. So, it did not matter that equity intervened in specific kinds of commercial relationships between vendors and purchaser, partners, or as transpired later during the 18th century, debtors or insurers. It was only later, in the 19th century that the concern that equity should not intervene in commercial relationships became apparent.<sup>268</sup> But, even so, these additional situations survived the 'decline' of equity.<sup>269</sup>

Thirdly, the operation of the mechanisms and doctrines were limited to specific factual situations. For example, the equitable assignment of future property is inherently limited. The equitable lien was (and is) generally available in only limited circumstances (which have been recognised in some cases by centuries of

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<sup>261</sup> Holdsworth, above n 15, vol 8, 242-245; *Chapman v Tanner* (1684) 1 Vern 267; 23 ER 261.

<sup>262</sup> *Bullock v Knight* (1682) 2 Ch Cas 114; 22 ER 872; Holdsworth above n 15, vol 6, 256-257.

<sup>263</sup> Meagher, Gummow and Lehane, above n 58, [111]-[115]. In relation to equitable assignments note Holdsworth, above n 15, vol 7, 535-536.

<sup>264</sup> Meagher, Gummow and Lehane, above n 58, [115]; Holdsworth, above n 15, vol, 1, 465-466; *Aldrich v Cooper* (1803) 8 Ves Jun 382; 2 Ves Jun Supp 1181; 32 ER 402; 34 ER 1020; *Ex parte Kendall* (1811) 34 ER 199, 1196; *Webb v Smith* (1885) 30 Ch D 192; *Lewis v United States* 92 US 618 (1875).

<sup>265</sup> In relation to insurance see *Castellain v Preston* (1883) 11 QBD 380 Meagher and Gummow, above n 22, [931]-[945].

<sup>266</sup> W W Buckland, *Equity in Roman Law* (1911) 63-84.

<sup>267</sup> *Ibid* 47-55.

<sup>268</sup> PS Atiyah, *The Rise and Fall of Contract* (Clarendon Press, Oxford, 1979) 392-394.

<sup>269</sup> *Ibid*.

precedent).<sup>270</sup> It has been pointed out that the situations where the doctrine of subrogation may be utilised may be open.<sup>271</sup> However, some judges have opined that subrogation may be unsuited to new situations.<sup>272</sup> The scope of the marshalling doctrine was (and is) inherently limited to disputes between double and single fund (or security) holders of a common debtor.<sup>273</sup>

Fourthly, the equitable lien, equitable assignment of property with consideration and the accessory doctrines of marshalling and subrogation were used to support contractual obligations rather than to set contracts aside. They supported the contractual intentions of the parties. For example, in the early case, *Chapman v Tanner*,<sup>274</sup> Chancery was willing to intervene and impose a vendor's lien to ensure that obvious intentions of the parties were sustained and an equitable result prevailed. Without the operation of equity an assignee of future property could be faced with providing consideration for property to which the assignee was not entitled. So too, in relation to the application of the doctrine of marshalling, courts have supported the original contract between the common debtor and the single security holder by enabling the single security holder to marshal against the remaining security of the double security holder. Without such a mechanism, the result would be disastrous for the single security holder (who would be demoted to the status of an unsecured creditor) and an unexpected advantage for the common debtor because only one rather than two securities would be realised.

It is probable that the additional situations where equity intervened were so entrenched in 19th century thinking that courts would not have been able to remove such tools from equity's armoury. And, it is most likely that in some cases (but not all cases) parties negotiated and entered into formal contracts and commercial relationships on the basis that these additional situations would be available if they were needed.

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<sup>270</sup> See generally Sunnucks, above n 208, [551]-[573].

<sup>271</sup> Meagher, Gummow and Lehane, above n 58, [952].

<sup>272</sup> Ibid [952]-[959]; cf Mitchell, above n 232, 8-15.

<sup>273</sup> For example, *Ex parte Kendall* (1811) 17 Ves Jun 514; 2 Ves Jun Supp 496; 34 ER 199; 34 ER 1196.

<sup>274</sup> (1684) 1 Vern 267, 268; 23 ER 461, 461.

Fifthly, these various doctrines and mechanisms were justified on the basis that the circumstances of the case and the relationship of the parties rendered one party conscience bound to the other party.<sup>275</sup> In the seminal Australian case concerned with equitable liens, *Hewett v Court*,<sup>276</sup> Deane J pointed out, in the context of a purchaser's lien, that:

the owner would be acting unconscientiously or unfairly if he were to dispose of the property (or, if it be appropriate, more than a particular portion thereof) to a stranger without the consent of the other party or without the actual or potential liability having been discharged.<sup>277</sup>

Therefore, he suggested that the lien in favour of a purchaser was imposed in order to ensure that the vendor acted in good conscience; or to put it another way, equity intervened to provide a purchaser with security against the failure of the vendor to honour his or her contractual undertakings.

A parallel approach can be identified in relation to the assignment of future property:

As the subject to be made over does not exist, the matter primarily rests in contract. Because value has been given on the one side, the conscience of the other party is bound when the subject comes into existence, that is, when, as is generally the case, the legal property vests in him. Because his conscience is bound in respect of a subject of property, equity fastens upon the property itself and makes him a trustee of the legal rights or ownership for the assignee.<sup>278</sup>

The accessory doctrines of marshalling and subrogation are concerned with the protection of the interests of creditors. Judges<sup>279</sup> and commentators<sup>280</sup>

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<sup>275</sup> See the discussion of Waters concerning vendors and purchasers and the language of trusts in Waters, above n 151, 74-75.

<sup>276</sup> (1983) 149 CLR 639.

<sup>277</sup> Ibid 668.

<sup>278</sup> *Palette Shoes Pty Ltd v Krohn* (1937) 58 CLR 1, 27 (Dixon J).

<sup>279</sup> *Yonge v Reynall* (1852) 9 Hare 809, 818-819; 68 ER 744, 748-749; *Cochrane v Cochrane* (1985) 3 NSWLR 403, 405 (Kearney J); *Lord Napier and Ettrick v Hunter* [1993] AC 713, 738 (Lord Templeman).

<sup>280</sup> Glover, above n 234, [1501]; Dal Pont and Chalmers, above n 100, 246.

acknowledge that subrogation exists in order to prevent unconscionable advantage taking and an unconscionable result. The major trend which characterises all subrogation cases is that liabilities, whether for debts or wrongs are brought home to the debtor and/or wrongdoer.<sup>281</sup> But the doctrine of subrogation also operates against the conscience of victims of wrongs, who have received double compensation from the wrongdoer and the insurer.<sup>282</sup> The doctrine of marshalling also developed as a means of redressing what would otherwise be an unjust result.<sup>283</sup> Thus, whilst the double secured creditor is entitled to exercise its contractual rights against the double security, equity will intervene and marshal securities in order to avert an unjust or unfair outcome.

The question in relation to the additional cases discussed is, why has equity intervened, or more accurately, why have courts of equity considered that there would be an unconscionable result if equity did not intervene? It is submitted that an answer which accurately reflects how these additional doctrines operate would highlight not only the unconscionable conduct, but also the assumption of risk. A party entitled to the lien, an effective assignment of future property (particularly supported by valuable consideration), subrogation or marshalling should not bear the ultimate risk of the insolvency and the status of unsecured creditor. Thus, despite the fact that such a party is intimately involved in a commercial transaction in which the assumption of risk is normative, the circumstances are such that the party did not assume the risk or ought not be expected to assume the risk of the transaction. This was alluded to by Murphy J in *Hewett v Court*<sup>284</sup> when he held that an equitable lien was appropriate in a case where purchasers of a prefabricated home (who had paid a deposit on the home)

cannot be expected to inquire into the solvency of the person with whom they are dealing.<sup>285</sup>

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<sup>281</sup> Ibid.

<sup>282</sup> *Lord Napier and Ettrick v Hunter* [1993] AC 713, 738 (Lord Templeman).

<sup>283</sup> *Commonwealth Trading Bank v Colonial Mutual Life Assurance Society Ltd* [1970] Tas SR 120, 126 (Neasey J).

<sup>284</sup> (1983) 149 CLR 639.

<sup>285</sup> Ibid 651.



In other respects, for example, in respect of fire risk, they may have been expected to insure against loss. But their assumption of risk did not extend to the insolvency of the builder. What is important here is that the concept of risk assumption may explain why courts exercising equitable jurisdiction intervene in some commercial transactions (which stand outside the traditional trust and fiduciary framework) and not in others.

It is arguable that the efficacy of equitable assignment of property for valuable consideration is explicable on the basis of non-assumption of risk for two reasons. First, the assignee did take action to protect his commercial interest by insisting on the assignment or agreement to assign future property via the operation of the equitable assignment. Secondly, if equity did not intervene, it would mean that notwithstanding the purported assignment, the assignor would obtain the consideration for the property and retain the property. This is an example of unconscionable retention of property which is discussed further.<sup>286</sup>

Subrogation and marshalling are examples of a risk analysis at work and this is incontrovertibly shown where the debtor or wrongdoer is insolvent. A party entitled to subrogation or marshalling of assets has an accessorial security mechanism which may effectively circumvent the insolvency of the debtor. Where the marshalling of securities is concerned, the single security holder actively took steps to protect themselves against the insolvency of the common debtor. The doctrine of marshalling preserves the single creditor's secured status to access the remaining security in the hands of the double secured creditor to the extent that they would have been protected under the original security.<sup>287</sup> Otherwise, despite legitimate and appropriate attempts to protect its interests, the single security holder would be relegated to the status of an unsecured creditor.

The doctrine of subrogation is explicable on the basis that a party only assumes a limited kind of risk. For example, insurers take on the risk of injury and loss to the insured. But that risk taking is limited to the relationship of the insured and the insurer. As soon as the insurer has undertaken its responsibilities to the insured, paid compensation and legally (if not factually) negated loss, the insurer has assumed the loss which the insured has suffered. Then, the insurer is entitled to repatriate the loss to the party who was the wrongdoer. Thus, the insurer stands in the

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<sup>286</sup> Chapter 5, 189-195.

<sup>287</sup> McDonald, above n 248, [1604]; Meagher and Gummow above n 22, [1101]-[1103].

shoes of the insured and may commence litigation against the wrongdoer for the loss. The double compensation situation in *Lord Napier and Ettrick v Hunter*<sup>288</sup> merely highlighted a variation of this theme. The insurer took on the risk of loss and, when that loss occurred assumed that loss in the form of payments to the insureds. At that point, the insurer's risk taking came to an end in the sense that it was entitled to repatriate the loss to the wrongdoers. But, before it could achieve this, the wrongdoer indemnified the insureds. Thus, as far as the wrongdoer was concerned, the wrongdoer had assumed the loss for which it was responsible - which incidentally is one of the functions of the doctrine of subrogation.<sup>289</sup> As the wrongdoer had assumed the loss, the insurer was entitled to a lien over the damages settlement.

A risk analysis may also be applied to those situations where an unsecured creditor makes a loan which pays out a secured creditor on the basis that there is a direct connection between the pay-out and the pre-existing securities. Courts have distinguished cases where the lender advances the money to pay out the mortgage to the mortgagee (where subrogation will be available) and cases where funds are lent to the mortgagor who then pays out the mortgage (where the doctrine of subrogation is not available).<sup>290</sup> It is presumed that the incoming lender has taken on the risk of lending subject to, and supported by, the ongoing operation of the mortgage for its benefit. It is arguable that the incoming lender has assumed risk on the basis that the pre-existing securities remain on foot and operate in the lender's favour.

## VI CONCLUSION

In this chapter, two major themes, which are central to modern equitable jurisprudence have been pursued. First, the strong proprietary and security tools available in equity have been highlighted. It has been shown that traditionally, equity has not only availed beneficiaries under trusts and fiduciary obligations of proprietary and priority interests, but equity has also intervened in commercial relationships and provided forms of relief tantamount to trust and security interests. These additional cases survived the restraints placed on equity as a jurisdiction

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<sup>288</sup> [1993] AC 713. Note in this regard Malcolm Luey, 'Proprietary remedies in insurance subrogation' (1995) 25 *Victoria University of Wellington* 449, 450-457.

<sup>289</sup> Glover, above n 234, [1501].

<sup>290</sup> *Cochrane v Cochrane* (1985) 3 NSWLR 403, 405 (Kearney J); *Paul v Speedway Ltd (in liq)* [1976] 1 Ch 220.

during the 19th century and continue to effectively operate in commercial contexts. Secondly, whilst the underlying philosophical and legal foundations for the operation of equity have rested on notions of conscience, the concept of conscience is an evaluation as to whether the circumstances indicate that a party assumed the risk of the commercial transaction, including its unsecured status, in the event of the other party's insolvency. As demonstrated, courts have already concluded that beneficiaries under trusts and fiduciary obligations do not assume the risk of the insolvency of the trustee or the fiduciary. The additional doctrines and mechanisms are explicable as specific instances where equity jurisprudence has intervened on the basis that the relationship between such parties indicates that there has been a non-assumption of risk.

In the light of equity's powerful proprietary tools in insolvency contexts, it is not surprising that lawyers have sought to access these mechanisms for new situations. The problem has been (and continues to be) that accessorial techniques are grounded on two untenable assumptions. First, it is assumed that the extension and adaptation of equity's proprietary devices is a simple task which does not have attendant doctrinal difficulties. As will be shown in Chapter 3, there are doctrinal difficulties. Not all of the extensions are appropriate or workable adaptations of equity's traditional proprietary gateways. Secondly, it is assumed that the operation of proprietary mechanisms, in particular equitable tracing, requires a pre-existing and clear proprietary base. Or, to put it another way, it is appropriate to limit the operation of the trust, the equitable lien and equitable tracing to situations where there is a pre-existing and defined asset base. As will be shown in Chapter 4, the changing nature of money in the modern technological age means that an identifiable proprietary base requirement is not always helpful or practical.

## **Chapter 3**

### **EQUITABLE PROPRIETARY AND SECURITY INTERESTS: THE EXTENSION OF TRADITIONAL PROPRIETARY GATEWAYS**

## I INTRODUCTION

In the last chapter, traditional means by which equity has intervened and accorded an aggrieved party proprietary and a fortiori priority interests were considered. Although the trust, fiduciary obligations, tracing and the various other doctrines and mechanisms discussed, did not originally arise overtly in response to risk assumption, their subsequent adoption and adaptation in the commercial environment can be explained on the basis of a party's non-assumption of an unsecured status.

The function of this chapter is to show that some of the equitable mechanisms which were discussed in the last chapter have been used to extend proprietary interests which operate to protect an unsecured commercial party in the event of insolvency. However, such an appropriation of these equitable mechanisms to essentially commercial relationships has not been without some doctrinal difficulty. Along the road of refashioning these mechanisms, new questions and problems have arisen.

This chapter is divided into two distinct parts. The first part considers the adaptation of the express trust. The express trust is based on the concept of intention and so, the concept of intention will be a major focus of the discussion. The second part of the chapter focuses on traditional mechanisms which have been utilised to find or impose proprietary interests in commercial transactions where there is no evident intention to create a trust like security mechanism. The limitations inherent in each of these adapted mechanisms are discussed. It will be concluded that in the light of the various limitations, a new approach needs to be taken.

## II INTENTION AND THE EXPRESS TRUST

The important and standard requirement in relation to the express trust has been the necessity of certainty of intention to create it.<sup>1</sup> This requirement has been satisfied where a settlor or testator has unilaterally created a trust in writing.<sup>2</sup> In

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<sup>1</sup> *Knight v Knight* (1840) 3 Beav 148; 49 ER 58; *Rehnan v Malone* (1897) 1 NB Eq 506. For a discussion of this issue see DWM Waters, *Law of Trusts in Canada* (2<sup>nd</sup> ed, 1984) 107-117; RP Meagher and WMC Gummow, *Jacobs' Law of Trusts in Australia* (6<sup>th</sup> ed, 1997) [501]-[502]; HAJ Ford and WA Lee, *Principles of the Law of Trusts* (3<sup>rd</sup> ed, 1996) [2000]-2060].

<sup>2</sup> For a discussion of the trust as a security see Professor PD Finn's comments recorded in The Hon. Mr Justice LJ Priestley, 'The Romalpa Clause and the Quistclose Trust' in PD Finn (ed), *Equity and*

essentially commercial relationships, the express trust has been used as a means both of redefining standard commercial norms of risk assumption and creating a security device, namely via intention and ‘manifestation’ of intention. The notion of intention to create a trust has been expanded and redefined to accommodate the fact that commercial transactions are not the same as family trusts or testamentary trusts.

In commercial transactions, the mutualisation of intention to create an express trust has become apparent. A discussion of the issue will predominate in the first part of the chapter. However, it appears that a commercial party may be able to exercise unilateral intention and create a trust. After all, traditionally an express trust is created by the unilateral intention of a settlor or trustee. In *Re Kayford Ltd (in liq)*,<sup>3</sup> Megarry J countenanced the unilateral creation of a trust by a mail order company. The company received orders for goods, together with payments, from customers who were generally members of the public (as distinct from trade creditors). The company was having difficulty obtaining goods to fulfil orders and consequently faced the prospect of insolvency. The company paid the moneys received from the members of the public into a dormant and separate deposit account without seeking the concurrence of customers or advising them that it was doing so. The liquidators of the company took out a summons seeking a determination whether the funds were part of the company’s assets or whether the funds were held on trust for the customers. Megarry J held that the company’s deposit of the moneys in the account manifested an effective intention to create an express trust.<sup>4</sup> Therefore, the case is an example of unilateral intention to create a trust in a commercial relationship. However, whilst from the perspective of trust law, a valid unilateral declaration of trust was possible, there were other problematical matters, such as voidable preference issues, which may make such an exercise difficult in the future.<sup>5</sup>

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*Commercial Relationships* (1987) 217, 237 and Michael Bridge, ‘The *Quistclose* Trust in a World of Secured Transactions’ (1992) *Oxford Journal of Legal Studies* 333.

<sup>3</sup> [1975] 1 WLR 279.

<sup>4</sup> *Ibid* 281-282.

<sup>5</sup> For a discussion of some of the problems associated with the case see Donovan WM Waters, ‘Trusts in the Setting of Business, Commerce and Bankruptcy’ (1983) 21 *Alberta Law Review* 395, 417; Priestley, above n 2, 234-236; RM Goode, *Payment Obligations in Commercial and Financial Transactions* (1983) 18 fn 64; Meagher and Gummow, above n 1, [215]; Sarah Worthington, *Proprietary Interests in Commercial Transactions* (1996) 59-61.

## *A The Phenomenon of Mutual Intention to Create an Express Trust*

A more likely scenario is that two parties in a commercial transaction will mutually agree to create a trust relationship over property. Unlike the simpler family trust or testamentary trust, the trust relationship is created by two persons rather than one person. Therefore, the intention to create a trust becomes part of the contractual relationship between the parties. Indeed, it can be said that the intention to create a contract and the intention to create a trust are conflated into a mutual intention to regulate the relationship according to the terms of the contract and to allocate the commercial risk in accordance with the operation of the express trust. The mutual creation of the trust effects a substantial change in the assumption of risk. Therefore, a party who would normally have no proprietary interest in money which it has transferred or in money which is collected on its behalf, may retain a proprietary interest via the use of the trust.

The concept of mutual intention is not limited to commercial relationships. There are a significant number of cases where the issue of mutual intention to create a trust has been crucial in determining whether a wife or a person in a de facto relationship have had a proprietary interest in the matrimonial home or property associated with the de facto relationship.<sup>6</sup> The discussion here will concentrate on commercial transactions. Theoretically speaking, it is open to any commercial parties involved in the transfer and collection of money to create a trust. However, it is likely that certain kinds of transactions may incorporate or be tantamount to an express trust, such as the transfer of money for safe keeping,<sup>7</sup> the transfer of money for a specifically defined purpose (which limits the assumption of risk)<sup>8</sup> and the collection of money from the sale of an asset.<sup>9</sup> Instead of undertaking an encyclopedic description of such cases, it is more helpful to consider the major problems which

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<sup>6</sup> *Gissing v Gissing* [1971] AC 886; *Pettit v Pettit* [1970] AC 777; *Hepworth v Hepworth* (1963) 110 CLR 309; *Allen v Snyder* [1977] 2 NSWLR 685; *Grant v Edwards* [1986] Ch 638; *Green v Green* (1989) 17 NSWLR 343.

<sup>7</sup> Austin Wakeman Scott and William Franklin Fratcher, *The Law of Trusts* (4<sup>th</sup> ed, 1987) vol 1, § 8.1 but note those situations where a banker acts as a bailee rather than a trustee – see §5.1 of the same work.

<sup>8</sup> See the discussion of *Barclays Bank Ltd v Quistclose Investments Ltd* [1970] AC 567 below, 115-117.

<sup>9</sup> See the discussion of *Stephens Travel Service Pty Ltd (Receivers and Managers Appointed) v Qantas Airways Ltd* (1988) 13 NSWLR 331 below, 99-101.

may arise when attempting to show that an express trust regulates the commercial relationship.

### ***B The Juxtaposition of Debt and Trust***

The initial question which was resolved in *Barclays Bank Ltd v Quistclose Investments Ltd* ('*Quistclose*')<sup>10</sup> was whether a trust relationship could operate simultaneously with the standard debtor-creditor relationship. This important threshold question was determined in favour of the co-existence of debtor and creditor relationships with the operation of the trust. Lord Wilberforce said that the contrary view was untenable:

It means that the law does not permit an arrangement to be made by which one person agrees to advance money to another, on terms that the money is to be used exclusively to pay debts of the latter, and if, and so far as not so used, rather than becoming a general asset of the latter available to his creditors at large, is to be returned to the lender...

I should be surprised if an argument of this kind - so conceptualist in character - had ever been accepted. In truth it has plainly been rejected by eminent judges who from 1819 onwards have permitted arrangements of this type to be enforced, and have approved them as being for the benefit of creditors and all concerned. There is surely no difficulty in recognising the co-existence in one transaction of legal and equitable rights and remedies...I can appreciate no reason why the flexible interplay of law and equity cannot let in these practical arrangements, and other variations if desired: it would be to the discredit of both systems if they could not.<sup>11</sup>

He confirmed that the trust could be used in a highly effective way to reverse commercial norms associated with the debtor-creditor relationship. Despite reservations expressed by others that such an express trust should be limited to

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<sup>10</sup> [1970] AC 567.

<sup>11</sup> Ibid 581-582.



money lent to discharge obligations,<sup>12</sup> it has been the view that such express trusts may operate in a wide range of transactions.<sup>13</sup>

Since the decision in *Quistclose*, parties have mutually agreed that the proceeds of sale of goods can be held on express trust for and on behalf of the owner of the goods.<sup>14</sup> This is a highly effective device, particularly where the agent has provided a floating charge to a third party and the owner has sought a security interest over the proceeds of sale only. In this way, in the event of insolvency, the owner has been assured that the sale proceeds would not form part of the assets of the insolvent agent.

There are two reasons why the trust has been utilised in this way. First, the standard commercial method of dealing with the sale proceeds has been quite different. Despite the fact that the selling party may be an agent of the owner of the goods, the fiduciary obligations of the agent do not extend to the obligation of holding the sale proceeds on trust for the owner.<sup>15</sup> After all, it has been established that there are different kinds of fiduciary obligations which have different rights and responsibilities attached to them.<sup>16</sup> Thus, Glover states:

Equity attaches considerable significance to the way in which an agent receives his principal's money. Money paid by third parties to agents on behalf of principals is treated differently from money that the principal directly receives. There is no rule that equity will regard money as possessing the same character as the underlying property that it represents. Further...prices received for the consigned cargo or the equipment sold are not themselves entrusted. Proceeds received in either case are not given by the principal into the agent's care, because they are not the principal's to give at the relevant time. The money came from a third party. The point of the transaction for the principal was to use the agent to get the money from someone else.

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<sup>12</sup> *Re Miles: Ex parte National Australia Bank Ltd v Official Receiver in Bankruptcy* (1988) 20 FCR 194, 199 (Pincus J).

<sup>13</sup> Meagher and Gummow, above n 1, [216].

<sup>14</sup> See the discussion of *Stephens Travel Service International Pty Ltd (Receivers and Managers Appointed) v Qantas Airways Ltd* (1988) 13 NSWLR 331 below, 99-100.

<sup>15</sup> See for example, *Walker v Corboy* (1990) 19 NSWLR 382; *Hydro-Electric Power Commission of Ontario v Brown* [1960] OR 91; (1960) 21 DLR (2d) 551; *Re HB Haina & Associates Incorporated* (1978) 28 CBR (NS) 113; (1978) 86 DLR (3d) 262.

<sup>16</sup> For example, *Kelly v Cooper* [1993] AC 205.

Nor is the money entrusted by the third party who pays it. It is simply the consideration in an ordinary commercial exchange: the price of grain or equipment purchased.<sup>17</sup>

The implementation of the mutual express trust is a response by commercial parties to the unenviable situation where, between the date of sale of the chattels and the date of accounting for the sale proceeds, the debtor-agent becomes insolvent. Thus, the mutual intention to create a trust operates to reverse the standard characterisation and transformation of what is essentially an initial bailment and principal and agent relationship<sup>18</sup> into a secured debtor-creditor relationship. The trust operates as a device to retain or obtain proprietary interest in money.

Secondly, the technical means by which the creditor is able to retain a legal or equitable interest in the proceeds of sale is limited. It is impossible for the legal owner of the property to take security over that property. However, there is a hiatus in the proprietary interest trail when the asset is sold. The trust device is an ingenious means by which, simultaneously, the owner retains an interest in the goods and then the sale proceeds (whilst the money itself operates as a normal negotiable entity). Obviously, it may be open to the creditor-principal to seek alternative security to counterbalance the fact that he or she will not retain a proprietary interest in the chattels. However, there may be no such suitable property. The agent's assets may already form security for other commercial commitments and the provision of additional security may interfere with other security arrangements. As the chattel was not the property of the debtor in the first place, it makes sense that a new security arrangement should relate to the proceeds from the sale of the chattel.

One example is *Stephens Travel Service International Pty Ltd (Receivers and Managers Appointed) v Qantas Airways Ltd ('Stephens')*.<sup>19</sup> In that case Qantas and Stephens Service International Pty Ltd ('Stephens') entered into a travel agency contract under which Stephens sold airline tickets and transportation orders owned by Qantas and agreed to collect and hold the proceeds in trust for Qantas. Stephens

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<sup>17</sup> John Glover, *Commercial Equity: Fiduciary Relationships* (1995) [3.73]. See also in this regard John Brunyate, *Limitation of Actions in Equity* (1932) 85-87; Paul Finn, 'Fiduciary Law and the Modern Commercial World' in Ewan McKendrick (ed), *Commercial Aspects of Trusts and Fiduciary Obligations* (1992) 7, 17-18.

<sup>18</sup> For a discussion of the nature of bailment and its applicability to money see NE Palmer, *Bailment* (2<sup>nd</sup> ed, 1991) 1-7, 13, 178-182.

<sup>19</sup> (1988) 13 NSWLR 331.

paid the funds it received for the airline tickets and transportation orders into an overdraft account with ANZ Bank Ltd ('ANZ'). ANZ demanded payment for an overdraft facility and Stephens was unable to pay. Consequently, ANZ appointed receivers and managers to Stephens pursuant to a floating charge over Stephens' assets. The question was whether a trust had been created. Hope JA, who delivered the unanimous decision of the Court, held that the parties had mutually created a trust under the agreement and that such a trust could operate within the context of a debtor-creditor relationship to reverse commercial norms. The use of the trust in this context has become so effective that the incorporation of an express trust has become part of many standard arrangements between travel agents and airlines in a variety of jurisdictions.<sup>20</sup>

However, the expansion of the concept of intention to include mutual intention has not been without the need to re-adjust other equitable requirements, particularly where money, rather than specific assets, has been the subject of the dispute.

First, the wider reading of the concept of intention has necessitated the re-interpretation of the criteria of certainty of subject matter. In *Stephens*, whilst there was clearly an intention to create a trust, there was the issue whether there was certainty of subject matter to which the trust attached. The problem was that the agreement did not contain a requirement that the agent retain the sale proceeds in a separate account. Moreover, the sale funds were in fact deposited in the trustee's general overdrawn account. Hope JA held that the absence of an express separate account provision would not render a trust invalid.<sup>21</sup> Indeed, he pointed out that there was evidence to suggest that payment of the funds into a separate account would have been commercially and practically difficult for Stephens.<sup>22</sup> The fact that the funds had been mixed in a general account did not negate the existence of the trust.<sup>23</sup> Rather, it led to an inquiry as to what was the effect of the breach of trust and the

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<sup>20</sup> See *Air Traffic Conference v Downtown Travel Center Inc* (1976) 14 AVI (CCH) 17,172; *Forastieri v Eastern Airlines Inc* (1983) 18 AVI (CCH) 17, 145; *Air Canada v M & L Travel Ltd* [1993] 3 SCR 787.

<sup>21</sup> (1988) 13 NSWLR 331, 341-342.

<sup>22</sup> *Ibid.*

<sup>23</sup> See also *Air Canada v M & L Travel Ltd* [1993] 3 SCR 787, 804 (Iacobucci J).

mixing of the funds<sup>24</sup> and the application of equity's tracing rules.<sup>25</sup> However, the effect of such a judgment was to qualify the requirement for specific and clear subject matter of the trust. Where money or other fungible items are involved,<sup>26</sup> this may be a necessary and logical response to the practicalities of commercial transaction and the changing nature and function of money.<sup>27</sup> Certainly, it is strongly arguable that an entry on the agent's balance sheet would have been sufficiently practical to indicate the existence of the subject matter of the trust.<sup>28</sup> After all, it has been decided that the opening of a separate account is only an indication of intention to create a trust.<sup>29</sup>

Secondly, the intrusion of an agreed express trust inevitably affects third parties. The effect of such an express trust is to withdraw assets from the property base of the insolvent party who is characterised as a trustee.<sup>30</sup> Therefore, secured creditors, particularly floating chargees,<sup>31</sup> are faced with the situation that when the charge crystallises, the property which is subject to the trust will not form part of the assets upon which the charge crystallises. This is precisely the problem which ANZ faced in *Stephens*. Thus, it is inconsequential whether or not the chargee has had notice of the existence of the trust because the trust operates quite separately from notice.

The existence of the trust will not be notified on any publicly accessible register. The security arrangement created by the mutually intended express trust remains one essentially known to the parties and (as in *Stephens*)<sup>32</sup> commercial parties such as the ANZ in *Stephens* who are involved with the day to day

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<sup>24</sup> (1988) 13 NSWLR 331, 345-348.

<sup>25</sup> Ibid 345-350.

<sup>26</sup> See *Hunter v Moss* [1994] 1 WLR 452.

<sup>27</sup> Chapter 1, 14-15.

<sup>28</sup> *Ausintel Investments (Aust) v Lam* (1990) 19 NSWLR 637, 648 (Meagher JA).

<sup>29</sup> *Re Nanwa Gold Mines* [1955] 1 WLR 1080; *Re HB Haina & Associates Incorporated* (1978) CBR (NS) 113; (1978) 86 DLR (3d) 262.

<sup>30</sup> *Bankruptcy Act 1966* Cth) s 116 (2) (a).

<sup>31</sup> William James Gough, *Company Charges* (2<sup>nd</sup> ed, 1996) 85-90.

<sup>32</sup> (1988) 13 NSWLR 331.

relationship between them. Thus, it could be argued that both unsecured and secured creditors (particularly floating chargees in the latter category) are faced with the unenviable task of trying to ascertain what are the assets of a debtor without the availability of accurate and verifiable information. This could be solved by the implementation of a register of trusts in relation to all property. So far, in relation to a major property register, this kind of scheme has not been favoured even in relation to Torrens Title land.<sup>33</sup> However, such a registration scheme has been implemented in relation to the company charge.<sup>34</sup>

Nonetheless, it remains that commercial parties have open to them the possibility to negotiate arrangements which have security implications. The effectiveness of the security arrangement between the parties has not been undermined by concerns for other third parties. Courts are averse to setting such arrangements aside simply on this basis<sup>35</sup> (particularly where the third party has knowingly received the trust money).<sup>36</sup> Prima facie, it is the responsibility of third party creditors to set, negotiate and implement their own effective security arrangements. Only in limited, albeit significant situations, will equity be called upon to review the order of priorities and intervene on behalf of unsecured creditors.<sup>37</sup> And the fact that a trust is not notified on a public register is not one of them. At any rate, in converse situations, the asset base of the debtor is unaffected by the fact that the debtor is a beneficiary under a trust. The assets of a beneficiary under a trust form part of that beneficiary's assets for distribution between creditors, except in cases of

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<sup>33</sup> For arguments that trusts ought to be registered see Robert Stein, 'Torrens Title – A Case for the Registration of Trusts in New South Wales' (1982) 9 *The Sydney Law Review* 605; Douglas J Whalan, 'Partial Restoration of the Integrity of the Torrens System Register: Notation of Trusts and Land Law Planning Control' (1970) 4 *New Zealand Universities Law Review* 1.

<sup>34</sup> In relation to company charges see *Corporations Law* (Cth) Part 3.5; HAJ Ford, RP Austin and IM Ramsay, *Ford's Principles of Corporations Law* (8<sup>th</sup> ed, 1997) [19.340]-[19.450].

<sup>35</sup> For cases which show what are the kinds of factors which may determine the existence of an express trust, see for example, the judgment of Gummow J in *Re Australian Elizabethan Theatre Trust* (1991) 102 ALR 681 and the judgments of Tompkins J and the Court of Appeal in *General Communications Ltd v Development Corporation of New Zealand* [1990] 3 NZLR 406.

<sup>36</sup> See for example, *Barclays Bank Ltd v Quistclose Investments Ltd* [1970] AC 567, 582 (Lord Wilberforce); *Stephens Travel Service International Pty Ltd (Receivers and Managers Appointed) v Qantas Airways Ltd* (1988) 13 NSWLR 331.

<sup>37</sup> For a discussion of this issue see Chapters 5 and 6 below.

protective and discretionary trusts.<sup>38</sup> It is only when the debtor is a trustee that the assets are treated as separate from the assets of the debtor for the purpose of insolvency administration.<sup>39</sup>

### *C Manifestation of Intention*

In the absence of clearly delineated written statements creating a trust or oral statements in which the intention to create a trust has been made, courts have resorted to other criteria in order to sustain the view that there has been an intention to create a trust. Courts have held that the parties have acted in a way which ‘manifested’ an intention to create a trust. The concept of manifesting an intention to create an express trust is well established in trust law where the unilateral intention of a ‘settlor’ has been involved.<sup>40</sup>

So too, in other cases, the important question will be whether the party (or parties, as the case may be) manifested sufficient intention to create a legal relationship which was tantamount to a trust. Courts will infer an intention to create a trust,<sup>41</sup> considering the nature of the transaction, the conduct of the parties and the circumstances of the case.<sup>42</sup> But, there is no one single method indicating intention. Therefore, it is unnecessary for the words ‘trust’ or ‘trustee’ to be used.<sup>43</sup> On the other hand, it has been well established that the use of the words ‘trust’ and ‘trustee’

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<sup>38</sup> *Re Coram; Ex parte Official Trustee in Bankruptcy v Inglis* (1992) 36 FCR 250; *Dwyer v Ross* (1992) 34 FCR 463.

<sup>39</sup> *Bankruptcy Act 1966* (Cth) s 116 (2) (a).

<sup>40</sup> *Re Armstrong* [1960] VR 202; *Paul v Constance* [1977] 1 WLR 527; Ford and Lee, above n 1 [2010].

<sup>41</sup> *Bahr v Nicolay* (No 2) (1988) 164 CLR 604, 618-619 (Mason CJ and Dawson J); cf the apparently narrow approach in *Re Schebsman: Ex parte Official Receiver v Cargo Superintendents (London) Ltd* [1944] Ch 83, 104 (du Parq LJ).

<sup>42</sup> *Trident General Insurance Co Ltd v McNeice Bros Pty Ltd* (1988) 165 CLR 107, 121 (Mason CJ and Wilson J), 147-149 (Deane J); *Swain v The Law Society* [1983] 1 AC 598, 621 (Lord Brightman); *Walker v Corboy* (1990) 19 NSWLR 382, 395-396 (Meagher JA); *Winterton Constructions Pty Ltd v Hambros Australia Ltd* (1991) 101 ALR 363, 370-371 (Gummow J).

<sup>43</sup> *Re Armstrong* [1960] VR 202; *Paul v Constance* [1977] 1 WLR 527; *Brisbane City Council and Myer Shopping Centres Pty Ltd v Attorney-General for Queensland* [1979] AC 411, 421; Scott and Fratcher, above n 7, vol I, § 24, 250.

may not indicate an intention to create a trust.<sup>44</sup> A direction to a party to hold that property for a third party may be sufficient to manifest an intention to create a trust.<sup>45</sup>

The flexible approach to certainty of intention reflects the inherent emphasis on the substance of the transactions over form.<sup>46</sup> Essentially, equity looks to the intent, rather than to the form.<sup>47</sup> Thus, it has been recognised that equity's capacity to infer trusts where no words of trust are used, is an example of the application of this maxim of equity.<sup>48</sup> Whilst it has been pointed out that the equitable maxim 'is not a boundless power in equity' and it 'is applied only in cases where the intention of the party is clear',<sup>49</sup> it appears that the interpretation of intention has been wide. Indeed, it has been suggested that there have been a number of cases where the evidence upon which the manifestation of intention to create a trust was minimal.<sup>50</sup> Sceptics such as the realist philosopher, Frank would devastatingly opine:

Someone has observed that whenever a lawyer says that something or other was the manifest intention of a man, 'manifest' means that the man never really had such an intention.<sup>51</sup>

Frank's statement highlights the fact that an obvious (yet powerful) criticism that the outward indications of intention may not manifest an intention to create a trust at all.

Into this complex and intuitive area of intention to create a trust, there is now the added dimension of mutual intention to create a trust in commercial relationships. Where the parties have mutually intended to create a trust in writing, then the

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<sup>44</sup> *Commissioner of Stamp Duties (Queensland) v Joliffe* (1920) 28 CLR 178. For a discussion of some of the complexities which arise in an analysis of intention see Scott and Fratcher, above n 7, vol IA, § 58-§58.1.

<sup>45</sup> Scott and Fratcher, above n 7, vol I § 24.

<sup>46</sup> *Parkin v Thorold* (1852) 16 Beav 59, 66; 51 ER 698, 701; *Solomons v Halloran* (1906) 7 SR (NSW) 32, 42. For a full discussion of the maxim see RP Meagher, WMC Gummow and JRF Leane, *Equity Doctrines and Remedies* (3<sup>rd</sup> ed, 1992) [331]-[338].

<sup>47</sup> Meagher, Gummow and Leane, above n 46, [311].

<sup>48</sup> Ibid.

<sup>49</sup> GE Dal Pont and DRC Chalmers, *Equity and Trusts: In Australia and New Zealand* (1996) 11.

<sup>50</sup> Patrick Parkinson, 'Chaos in the Law of Trusts' (1991) 13 *The Sydney Law Review* 227, 232-234.

<sup>51</sup> Jerome Frank, *Law and the Modern Mind* (1930) 27.

situation is a relatively clear one, subject to the difficulties pointed out earlier in this chapter. However, where there is no express intention, courts will consider the circumstances of cases,<sup>52</sup> including whether there has been segregation of assets.

### ***D Segregation of Assets***

There are cases which establish that the segregation of assets, particularly, money, can be important means of manifesting an intention to create a trust (as well as providing an identifiable subject matter).<sup>53</sup> Where money is involved, the segregation method reverses the standard commercial norms in relation to the passing of title.<sup>54</sup> The recipient has only acquired a legal interest in the money by virtue of possession. The money has been stripped of its negotiability. The express requirement to segregate the money reifies the money into a separate and distinct fund. As a fund, the money becomes a distinct asset which is capable of identification and being the subject matter of a trust.<sup>55</sup>

#### **1 Origins of the Segregation Requirement**

The segregation method may have originated in common law rather than in equity. Three examples indicate that this was probably the case. First, during the 16th and 17th centuries there were common law cases which held that money could only be the subject of common law actions of detinue, trover or conversion if the money was described or identified<sup>56</sup> by storage in a bag,<sup>57</sup> (although some cases

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<sup>52</sup> *Trident General Insurance Co Ltd v McNeice Bros Pty Ltd* (1988) 165 CLR 107, 121 (Mason CJ and Wilson J), 147-149 (Deane J).

<sup>53</sup> A few examples are *Moseley v Cressey's Co* (1865) LR 1 Eq 405; *Henry v Hammond* [1913] 2 KB 515; *Cohen v Cohen* (1929) 42 CLR 91; *Re Associated Securities Ltd and the Companies Act* [1981] 1 NSWLR 742; *Re Australian Elizabethan Theatre Trust* (1991) 102 ALR 681; *Re Multi Guarantee Co Ltd* [1987] BCLC 257; *Carreras Rothmans Ltd v Freeman Mathews Treasure Ltd* [1985] Ch 207; *Steffanson v Jaasma and Jaasma* [1976] 4 WWR 449; *Farmers State Bank of Farmers State Bank of Forston v Sig Ellingson & Co* 16 NW (2d) 319 (SC Minnesota, 1944); *Cohen v Cohen* 20 A (2d) 594 (SC New Jersey, 1941). Note also American Law Institute, *Restatement of the Law of Trusts* 2nd (1959) vol 1, §12 g.

<sup>54</sup> For the standard norms see Chapter 1, 12-13.

<sup>55</sup> Worthington, above n 5, 61-62.

<sup>56</sup> See for example *Rivers v Oodskirt* Cro Eliz 568; 78 ER 812.



appear to suggest that trover was available notwithstanding lack of such identification).<sup>58</sup> So too, modern detinue permits recovery of goods but as such requires identification of goods (including money) wrongfully detained.<sup>59</sup> The modern tort of conversion encompassing trover<sup>60</sup> is available where there has been serious interference with the right of another to control a chattel.<sup>61</sup> An action will lie if the chattel or money is specifically identified.<sup>62</sup> Fleming observes in relation to conversion, 'the action is proprietary in substance, only tortious in form.'<sup>63</sup> The fact that the remedy is damages<sup>64</sup> does not detract from the fact that the initial chattel over which there is dispute must be sufficiently identifiable.<sup>65</sup>

Secondly, the common law emphasis on segregation has occurred where the sale and passing of title in relation to fungibles, other than money, has been involved. The relevant legislation is the *Sale of Goods Act 1979* (UK)<sup>66</sup> which replaced the

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<sup>57</sup> *Banks v Whetson*, Cro Eliz 457; 78 ER 711; *Clark's Case* Godbolt 210; 78 ER 128; *Issack v Clarke* (1688) 2 Bulstrode 306; 80 ER 1143; *Draycott v Piot* Cro Eliz 818; 78 ER 1045; *Taylor v Plumer* (1815) 3 M & S 562; 105 ER 721.

<sup>58</sup> *Clark's Case* Godbolt 210; 78 ER 128; *Hall v Dean* Cro Eliz 841; 78 ER 1068.

<sup>59</sup> For a helpful discussion of detinue see RP Balkin and JLR Davis, *Law of Torts* (2<sup>nd</sup> ed, 1996) 107-109.

<sup>60</sup> John G Fleming, *The Law of Torts* (9<sup>th</sup> ed, 1998), 60-66.

<sup>61</sup> Ibid 60-61; Balkin and Davis, above n 59, 77-87. As to the chattels see in relation to cars: *Union Transport Finance Ltd v British Car Auctions Ltd* [1978] 2 All ER 385; *Motor Mercantile Co Ltd v Twitching* [1977] AC 890; timber: *Berry v Heard* (1632) Cro Car 242; 79 ER 812; *Pyne v Dor* (1785) 1 Term Rep 55; 99 ER 968; *Blackett v Lowes* (1814) 2 M & S 494; 105 ER 465.

<sup>62</sup> Ibid 60-61. See also *Brambles Security Service Ltd v By-Lo Pty Ltd* (1992) Aust Torts Reports ¶181-161, ¶161, 269-61, 270; Balkin and Davis, above n 59, 75.

<sup>63</sup> Ibid 61.

<sup>64</sup> Ibid 76-78.

<sup>65</sup> Ibid 60-61. See also in relation to conversion Edward H Warren, 'Qualifying as Plaintiff in Action for Conversion' (1936) 49 *Harvard Law Review* 1084; William L Prosser 'The Nature of Conversion' (1957) 42 *Cornell Law Quarterly* 168.

<sup>66</sup> Note equivalent legislation has been enacted in the Australian States such as *Sale of Goods Act 1923* (NSW); *Goods Act 1958* (Vic); *Sale of Goods Act 1896* (Qld); *Sale of Goods Act 1895* (SA); *Sale of Goods Act 1896* (Tas); *Sale of Goods Act 1895* (WA).

earlier *Sale of Goods Act 1893* (UK).<sup>67</sup> Prior to the original codification, the common law required that where an executory contract for the sale of goods was entered into, it became an executed contract upon the specification or appropriation of the goods to that contract.<sup>68</sup> Under the original codification, a contract for the sale of unascertained goods did not amount to a sale but simply to an agreement to sell, that is, an executory rather than an executed agreement.<sup>69</sup>

The concept of unascertained goods refers to where there are generic goods,<sup>70</sup> from which part is identified and title thereupon passes.<sup>71</sup> It had been argued unsuccessfully that prior to the appropriation of a part from a larger bulk, the purchaser acquired an equitable interest in the bulk.<sup>72</sup> Therefore, the position was changed under the UK legislation<sup>73</sup> and there have been calls for reform in Australia as well.<sup>74</sup>

Thirdly, the prevailing interpretation<sup>75</sup> (but by no means the universal one)<sup>76</sup> of what constitutes common law following, confirms that the segregation of

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<sup>67</sup> For a general discussion of the earlier legislation see LS Sealy, 'The Contract of Sale of Goods' in AG Guest (ed), *Benjamin's Sale of Goods* (4<sup>th</sup> ed, 1992) 3, [1-002].

<sup>68</sup> Arthur Beilby Pearson-Gee and Hugh Fenwick Boyd, *Benjamin's Treatise on the Law of Sale of Personal Property* (4<sup>th</sup> ed, 1888) Chapter 5.

<sup>69</sup> *Badische Anilin und Soda Fabrik* [1906] AC 419; *Mischeff v Springett* [1942] 2 KB 331; *Preston v Albuery* [1964] 2 QB 796; *Re Wait* [1927] 1 Ch 606.

<sup>70</sup> *Re London Wine Co (Shippers Ltd)* (unreported, 7<sup>th</sup> November 1975, Oliver J) which is set out in RM Goode, *Property Rights and Insolvency in Sales Transactions* (1985) 95-130.

<sup>71</sup> *Re Wait* [1927] 1 Ch 606.

<sup>72</sup> Ibid; F Pollock, 'Notes: *Re Wait*' (1927) 43 *The Law Quarterly Review* 293; Meagher, Gummow and Lehane, above n 46, [666]-[684] *Re Goldcorp Exchange Ltd (In Receivership)* [1995] 1 AC 74.

<sup>73</sup> Robert Bradgate and Fidelma White, 'Sale of Goods Forming Part of a Bulk: Proposals for Reform' [1994] *Lloyds Maritime and Commercial Law Quarterly* 315; Lionel Smith, 'Bailment with Authority to Mix-and Substitute' [1995] 111 *The Law Quarterly Review* 10.

<sup>74</sup> Gail Pearson, 'The Transfer of Property in Unascertained Goods: Who Owns the Wine Bottles' (1997) 71 *The Australian Law Journal* 134.

<sup>75</sup> *Re Diplock* [1948] Ch 465; *Agip (Africa) Ltd v Jackson* [1991] Ch 547, 563; Michael Scott, 'The Right to 'Trace' at Common Law' (1965-1966) 7 *The University of Western Australia Law Review* 463, 465.

<sup>76</sup> See for example Lionel D Smith, *The Law of Tracing* (1997) 162-174.

fungibles such as money was essential. Further, the need for the physicality of identity was recognised by Millett J at first instance in *Agip (Africa) Ltd v Jackson*.<sup>77</sup> He held that common law following was not available against a party which had received electronically transferred funds.<sup>78</sup>

There are two major scenarios in relation to the segregation of assets in the context of manifestation to create a trust. The first kind is where the parties in the commercial relationship expressly agree in some way that the recipient of the funds will retain the funds separate and segregated from his own assets. Although the parties have not used any language denoting a trust, the effect of such an agreement is to create a trust relationship.<sup>79</sup> As the agreement to segregate reverses commercial norms, the party who has provided the funds (or in some cases the assets sold) retains an equitable interest in the funds or sale proceeds. Thus, it has protected itself against its otherwise unsecured status in the event of the insolvency of the other party.

Another method of *agreed* segregation, is where one party makes an unilateral statement (such as in an advertisement) in relation to the segregation of money upon receipt of the funds, and the other party enters into the transaction on the basis of that statement. In *Re Nanwa Goldmines Ltd*,<sup>80</sup> the subscription form for an issue of capital in a company stated that in the event that the subscribed shares were not allotted, 'application moneys will be refunded and meanwhile will be retained in a separate account.'<sup>81</sup> The allotment never took place and a receiver was appointed in relation to the company. Harman J said that the construction of the application form led to the conclusion that there was a representation that subscription moneys were kept separate. The funds were not part of the assets of the company but were returnable to the subscribers.

A third method of *agreed* segregation, is where one party entrusts assets to the other party on the clear understanding that that party will not only sell the assets

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<sup>77</sup> [1990] 1 Ch 265.

<sup>78</sup> Ibid 285-286.

<sup>79</sup> For a discussion of this issue in the context of *Barclays Bank Ltd v Quistclose* [1970] AC 567 see Worthington, above n 5, 55-56.

<sup>80</sup> [1955] 1 WLR 1080; cf *Re Hartney Co (1959) Ltd and Freed* (1962) 4 CBR (NS) 71.

<sup>81</sup> Ibid 1081-1082.

but will account the actual proceeds of sale to the owner of the goods. Whilst there is no express intention to create a trust over the moneys in the same way as in *Stephens*,<sup>82</sup> either the requirement of specific accountability of the money or the agreed segregation of the moneys into a specific fund, has been sufficient to create a trust. In *Cohen v Cohen*,<sup>83</sup> the wife had entrusted the sale of goods and collection of moneys to her husband. The couple had separated and the wife wanted her former husband to account to her for the sale proceeds. The problem was that her actions were statute barred under the relevant *Statute of Limitations*. The question was whether the husband held any of the sale proceeds on trust for his wife. The High Court held that as the wife had intended that the husband should account to her for the sale proceeds in relation to certain furniture, she had a proprietary interest in them. The husband did not simply owe a personal obligation to account for the money but was required to specifically account for it.<sup>84</sup>

The second method in relation to segregation is where one of the parties to the relationship simply segregates the money. There is no express agreement, but the circumstances leading up to the segregation of the money indicates that the segregation of the money into a fund, is the fulfilment of the negotiations. This was the effect of the segregation of the funds in *Quistclose*.<sup>85</sup>

## ***2 Problems Associated with the Segregation Model of Trust Creation***

Whilst segregation of moneys directly received from the transferor of funds or from the sale of chattels is an ingenious means by which to reverse commercial norms of risk assumption, the process has not been interpreted in a clear or consistent way. The risk analysis has not been used to explain segregation and this has led to a number of misunderstandings why and how segregation works in the context of trust law. It is strongly arguable that an emphasis on risk assumption rather than simply intention to create a trust explains many of the apparent anomalies in the case law.

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<sup>82</sup> (1988) 13 NSWLR 331.

<sup>83</sup> [1929] 42 CLR 91.

<sup>84</sup> Ibid 101-102.

<sup>85</sup> [1970] AC 567.

### ***(a) What Kind of Trust Does the Segregation Phenomenon Create ?***

The fact that the trust created by segregation of moneys is discussed under the heading of mutual intention to create a trust, indicates the author's view that the device is an express trust. There are some authorities which would support this view.<sup>86</sup> However, Lord Wilberforce stated in *Quistclose*:

That arrangements of this character for the payment of a person's creditors by a third person, give rise to a relationship of a fiduciary character or trust, in favour, as a primary trust, of the creditors, and secondarily, if the primary trust fails, of the third person, has been recognised in a series of cases over some 150 years.<sup>87</sup>

Thus, some commentators have suggested that the trust operates initially as an express trust, which subsequently fails, and a secondary trust repatriates the beneficial interest to the lender. The secondary trust has been interpreted as an express trust<sup>88</sup> and a resulting trust.<sup>89</sup> There have even been suggestions that the remedial constructive trust is more appropriate because it would be unconscionable for the money to be used in a way which was outside the agreement of the parties.<sup>90</sup>

The difference between the interpretations is based on whether the trust arises via the unexpressed intentions and conduct of the parties or, whether the trust is imposed on the basis of criteria which operates separate from the express or apparent

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<sup>86</sup> *Re Australian Elizabethan Theatre Trust* (1991) 102 ALR 681, 693-694 (Gummow J); Priestley, above n 2, 237; and effectively the conclusion of PJ Millett, 'The Quistclose Trust: Who Can Enforce It?' (1985) 101 *The Law Quarterly Review* 269, 290.

<sup>87</sup> *Ibid* 580.

<sup>88</sup> *General Communications Ltd v Development Finance Corporation of New Zealand Ltd* [1990] 3 NZLR 406, 419 (Tompkins J at first instance) and 432-3 (CA); *Re Australian Elizabethan Theatre Trust* (1991) 102 ALR 681, 691 (Gummow J).

<sup>89</sup> *Re Associated Securities Ltd and the Companies Act* [1981] 1 NSWLR 742, 749 (Needham J); *Re ETVR Ltd and Gilbert v Barber* [1987] BCLC 646, 650-651 (Dillon LJ); RM Goode, *Principles of Corporate Insolvency Law* (1990) 55; CEF Rickett, 'Different View on the Scope of the *Quistclose* Analysis: English and Antipodean Insights' (1991) 107 *The Law Quarterly Review* 608, 618; Bridge, above n 2, 352; Dal Pont and Chalmers, above n 49, 416; Robert Chambers, *Resulting Trusts* (1997), Chapter 3.

<sup>90</sup> IM Hardcastle, 'Purpose Trusts' how close to *Quistclose*?' (1988) 85 *The Law Society's Gazette* 14; *Dines Construction Ltd v Perry Dines Corporation* (1989) 4 NZCLC ¶96-330, (Ellis J). For a consideration of the relationship of the *Quistclose* trust and the constructive trust see David M Wright, *The Remedial Constructive Trust* (1998) [6.10].

intention of the parties. Such characterisations arise from a different interpretation of the facts. If the trust is the product of the unexpressed intentions and conduct of the parties (which is an agreement to segregate assets or the factual allocation of assets) then the trust arises by virtue of that intention. If the trust does not arise from the intention of the parties, then it will be imposed by existing legal rules which establish the resulting trust or imposed by the court pursuant to a constructive trust. However, the various arguments in relation to whether the trust or trusts should be characterised as one kind of trust or another, is an arid one. This is because the courts have found that a trust has regulated the commercial relationship between the parties; and, therefore the standard commercial norms in relation to dealing with money have been overturned. As has been shown,<sup>91</sup> various kinds of trusts have been used traditionally to protect a beneficiary from any risk of wrongdoing or insolvency of the trustee.

***(b) Is an Agreement to Segregate Essential Before an Express Trust Arises?***

Basically, the question is whether segregation will be effective to reverse commercial norms and create an express trust without the need for an actual agreement to segregate between the parties. This was one of the issues which was faced by the litigants in *Quistclose*.<sup>92</sup> A company in a poor financial situation borrowed money from a related company for the purpose of paying shareholders a dividend. In this context, the shareholders were not only stakeholders in the company, but also creditors as well. The money was deposited in a separate account. Before the money was used for the purpose for which it had been lent, the company went into liquidation and the question was whether the lender (*Quistclose Investments*) or the company's principal creditor (*Barclays Bank*) were entitled to the moneys. At first instance,<sup>93</sup> *Plowman J* held that, as the company was not required to keep the funds separate from its own, a trust did not arise in favour of the lender after the purpose failed.<sup>94</sup> In comparison, the higher courts clearly took the view that the omission of an actual obligation to segregate moneys was not damaging to the

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<sup>91</sup> Chapter 2, 50-60.

<sup>92</sup> [1970] AC 567.

<sup>93</sup> *Quistclose Investments Ltd v Rolls Razor Ltd (in liq)* [1967] Ch 910.

<sup>94</sup> *Ibid* 929- 931.

lender's case. The House of Lords,<sup>95</sup> affirming the decision of the Court of Appeal,<sup>96</sup> held that a trust arose in favour of the creditors and if the primary trust failed, in favour of the third party lender.<sup>97</sup> They apparently substituted other criterion, namely specific purpose, which evidenced the creation of an express trust without the need to address the lack of a strict requirement to segregate the assets. However, another possible reason why the segregation issue was not so important was because in fact (if not by way of obligation), the moneys were held in a separate account anyway.<sup>98</sup>

Another reason why the obligation to segregate the moneys was not so important was that the requirement to segregate the funds could be implied from the events which led up to the commercial transaction itself. Particular care had been taken to ensure that the funds were separate from the assets of the borrower. Substantial negotiations which took place indicated that the lender was wary of handing over money to the borrower.<sup>99</sup> It was clear that the lender was not willing to assume the risk of an unsecured status in the event of the insolvency of the borrower, except in the situation where the moneys which were lent were used to pay the dividends owing to the shareholders.<sup>100</sup>

Nonetheless, there is judicial authority which suggests that the mere segregation of money may not of itself create a trust.<sup>101</sup> Therefore, it is likely, as has been demonstrated above, that in the absence of express agreement, a plaintiff will have to demonstrate something more than the fact that the funds in dispute are factually segregated. The concept of special purpose is considered as a potential additional factor, although as will be shown, this criterion is ultimately unhelpful.<sup>102</sup>

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<sup>95</sup> [1970] AC 567.

<sup>96</sup> *Quistclose Investments Ltd v Rolls Razor Ltd (in liq)* [1968] 1 Ch 540.

<sup>97</sup> [1970] AC 580-581.

<sup>98</sup> *Ibid*, 579.

<sup>99</sup> [1968] 1 Ch 540, 550-552 (CA); [1970] AC 567, 579-580 (HL).

<sup>100</sup> *Ibid*.

<sup>101</sup> *Re Nanwa Gold Mines Ltd* [1955] 1 WLR 1080, 1084; *Re HB Haina & Associates Incorporated* (1978) 28 CBR (NS) 113; (1978) 86 DLR (3d) 262.

<sup>102</sup> Below, 112-114.

***(c) Is the Security Device Which Arises in the Form of a Trust a Product of the Intention of Both of the Parties or the Single Intention of One of the Parties?***

This is a question which is related to the issue immediately discussed, but in other respects quite separate from it. The question focuses on whether, in a consensual relationship, it is possible for one party to take action tantamount to creating a trust without the input of the other party. At first blush, it is arguable that the segregation phenomenon is generally the product of consensus. Therefore, the prospect of unilateral action which leads to the creation of a trust appears to be unlikely. After all, the segregation phenomenon is conflated into the express and mutual creation of a trust.<sup>103</sup> Not only does the transferor or owner of the goods seek to limit their assumption of risk, but the recipient of the funds must agree (in effect) that his use of the money is limited by the operation of the trust. Nonetheless, it is likely that it will be the initial intention of the lender or transferor to limit risk (such as in a *Quistclose* situation)<sup>104</sup> which will fuel the desire for a security arrangement in the form of a trust.<sup>105</sup>

***(d) In Whom Does the Equitable Interest Reside?***

One of the central requirements of the law of trusts is that there must be certainty of object.<sup>106</sup> Generally, trusts in favour of purposes rather than persons are invalid,<sup>107</sup> subject to exceptions including the tomb,<sup>108</sup> animal<sup>109</sup> cases and charitable

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<sup>103</sup> See the comments of The Honourable Mr Justice Priestley on an interpretation of the *Quistclose* trust by Professor PD Finn in Priestley, above n 2, 237.

<sup>104</sup> In relation to the emphasis on the lender or transferor's intention see Millett, above n 86.

<sup>105</sup> Worthington, above n 5, 53-55; 59-61.

<sup>106</sup> *Knight v Knight* (1840) 3 Beav 148; 49 ER 58; *Morice v Bishop of Durham* (1804) 9 Ves 399; 32 ER 656.

<sup>107</sup> *Morice v Bishop of Durham* (1804) 9 Ves 399; 32 ER 656; *Re Astor's Settlement Trusts* [1952] Ch 534; *Re Recher's Will Trusts* [1972] Ch 526.

<sup>108</sup> *Musset v Bingle* (1876) WN 170; *Pirbright v Salwey* [1896] WN 86; *Re Hooper* [1932] 1 Ch 38; *Re Filshie (Decd)*, *Raymond v Butcher* [1939] NZLR 91; *Re Budge (Decd)*; *Ex parte Pascoe* [1942] NZLR 350.

<sup>109</sup> *Pettingall v Pettingall* (1842) 11 LJ Ch 176; *Re Dean* (1889) 41 Ch D 552.



trusts.<sup>110</sup> It is strongly arguable that in the segregation cases, the beneficial interest will lie in the transferor of the funds (such as the lender in *Quistclose*) or the owner of the chattels which have been entrusted for sale. In this respect, an analysis based on a single express trust is preferable.

The alternative is the dual trust structure in which, for example, a secondary resulting trust repatriates the beneficial interest in the transferor of funds when it becomes clear that the 'purpose' of the trust fails or cannot be achieved. The evident problem in such a case is that it may be difficult to ascertain the precise purpose of the trust or whether the purpose of the trust is achievable. Indeed, some commentators have questioned whether the purpose of the primary trust in *Quistclose* was no longer capable of fulfilment.<sup>111</sup> Moreover, one commentator suggested that *Quistclose*<sup>112</sup> stood for the proposition that courts would uphold purpose trusts.<sup>113</sup> The primary trust in *Quistclose* was a non-charitable purpose trust followed by a secondary resulting trust in favour of the lender.<sup>114</sup> This was criticised at judicial level<sup>115</sup> and the commentator subsequently withdrew such an interpretation.<sup>116</sup>

Another suggestion in relation to the beneficial interest has been that the beneficial interest floats above the transaction. In fact, it does not attach to any party until the actual transfer of money to the designated recipient. In *Carreras Rothmans v Freeman Mathews Treasure Ltd* ('*Carreras*').<sup>117</sup> Freeman Mathews Treasure Ltd ('Freeman') was an advertising agency which had undertaken advertising services

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<sup>110</sup> *Re Gott* [1944] 1 Ch 193; *New Zealand Society of Accountants v Commissioner of Inland Revenue* [1986] 1 NZLR 147.

<sup>111</sup> William Goodhart and Gareth Jones, 'The Infiltration of Equitable Doctrine into English Commercial Law' (1980) 43 *Modern Law Review* 489, 494, fn 28; Ford and Lee, above n 1, [1390] fn 2; Chalmers, above n 89, Chapter 3.

<sup>112</sup> [1970] AC 567.

<sup>113</sup> Note generally Rickett, above n 89.

<sup>114</sup> *Ibid* 618.

<sup>115</sup> *Re Australian Elizabethan Theatre Trust* (1991) 102 ALR 681, 692 (Gummow J).

<sup>116</sup> Charles EF Rickett, 'Trusts and Insolvency: The Nature and Place of the Quistclose Trust' in Donovan WM Waters (ed), *Equity, Fiduciaries and Trusts 1993* (1993) 325, 332-333.

<sup>117</sup> [1985] Ch 207.

for Carreras Rothmans Ltd ('Carreras'). Freeman utilised the services of the various third parties and received the invoices for the services rendered. Each month, Carreras paid Freeman an amount equivalent to the total amount owing in relation to the invoices received for the previous month. This system worked well until Freeman had financial difficulties. Therefore, Carreras and Freeman agreed that a special account would be set up into which Carreras would deposit the moneys to pay the third parties. Funds were deposited and Freeman drew cheques on the account to pay the creditors. Freeman went into voluntary liquidation and the liquidator froze payment on the cheques prior to clearance. Peter Gibson J held that the funds in the account did not form part of Freeman's or Carreras' assets.<sup>118</sup> However, this mode of legal analysis was flawed. The circumstances which arose in *Carreras* were different from the loan made by a lender in *Quistclose* or a segregation arrangement made by an owner of chattels in respect of the proceeds of sale. In *Carreras*, Carreras deposited money in the account so that Freeman could withdraw the funds or issue cheques to pay debts which were essentially owed by Carreras. As Carreras owed money to the third parties, it is fairly clear that as against the third parties, Carreras did not wish to retain an interest in it. Whether or not the third parties became insolvent, did not affect Carreras' ultimate liability. The third parties, rather than Carreras, were the unsecured creditors. The account was set up in order to ensure that the funds did not become part of the general assets of Freeman. Therefore, whilst Freeman was not entitled to use the moneys as part of the general assets, there was no reason why the court could not have held that the beneficial interest resided in the third parties. If Carreras paid them directly, it would have been appropriate for the court to have ordered that the beneficial interest be repatriated to Carreras on the basis that the third parties had received payment twice.<sup>119</sup>

***(e) Is the Specific Purpose Which is Attached to the Funds Indicative of a Trust?***

It has been suggested that a trust arises where funds are transferred for a specific purpose.<sup>120</sup> This proposition probably arose from the judgment of Lord

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<sup>118</sup> Ibid 223-224.

<sup>119</sup> For analogous cases see Chapter 6, 271-272.

<sup>120</sup> See generally, Chambers, above n 89, Chapter 3.

Wilberforce himself in *Quistclose*,<sup>121</sup> where he quoted with apparent approval the judgment of Abbott CJ in *Toovey v Milne*<sup>122</sup> who said:

I thought at the trial, and still think, that the fair inference from the facts proved was that his money was advanced for a special purpose, and that being so clothed with a specific trust, no property in it passed to the assignee of the bankrupt. Then the purpose having failed, there is an implied stipulation, that the money shall be repaid. That has been done in the present case; and I am of opinion that that repayment was lawful, and that the nonsuit was right.<sup>123</sup>

Lord Wilberforce stated:

The basis for the decision was thus clearly stated, viz., that the money advanced for the specific purpose did not become part of the bankrupt's estate.<sup>124</sup>

His Lordship cited a variety of supporting subsequent authorities.<sup>125</sup> Notwithstanding such authority, the concept of special purpose should be used most carefully.

The concept of special purpose on its own will not assist a court to establish whether the parties intended to treat the moneys in a way distinct from standard commercial norms. For example, there are many unsecured loans which are expressed to be made for specific personal and business purposes. Yet, it could not be said that the money which represents the loan or the asset subsequently purchased or substituted, is subject to a trust. What is required is evidence of the express intentions of the parties or their conduct which shows that the money was not only transferred for a specific purpose, but that specific purpose represented the limited commercial risk which the transferor was willing to take. *Toovey v Milne* and *Quistclose* can be analysed on the basis of this limited assumption of risk. The facts of *Toovey v Milne* were simple. The moneys were lent for the specific purpose of

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<sup>121</sup> [1970] AC 567.

<sup>122</sup> (1819) 3 B & A 683; 106 ER 514.

<sup>123</sup> Ibid 684; 515; See also *Edwards v Glyn* (1859) 2 El & El 29; 121 ER 12; *Re Rogers; Ex parte Holland & Hannen* (1891) 8 Morrell's Reports of Cases under the Bankruptcy Acts 1883 & 1890, 243; *Re Drucker (No 1), Ex parte Basden* [1902] 2 KB 237; *Re Watson; Ex parte Schipper* (1912) 107 LT 783.

<sup>124</sup> [1970] AC 567, 580.

<sup>125</sup> Ibid.

assisting the bankrupt to pay out his creditors. When this did not (and apparently could not) eventuate, then the potential limited risk came to an end. Abbott CJ said that the property or title to the money did not pass to the insolvent. Title would not have passed unless the limited conditions in which the risk of unsecured creditor status occurred. So too, in *Quistclose* the lender had made it clear that it would assume the risk of insolvency only in the event that the money which was deposited in the account was used to pay dividends to shareholders. Otherwise, the risk of the borrower's insolvency would not be assumed. Thus, the concept of specific purpose is simply an additional factor which will define the extent of risk assumed and conditions under which the risk will be assumed. It does not, of itself, determine whether title to the money has passed and whether there has been an assumption of risk. It appears that this is the situation in the United States.<sup>126</sup>

Where a specific chattel has been transferred for sale, the fact that the chattel has been transferred specifically for the purpose of sale, does not of itself create a trust. It appears that the situation will be treated as a bailment, whether or not there is a specific purpose attached to the use or sale of the chattels. Indeed, there may be no special purpose attached to the chattel which is held by the recipient as bailee. When the goods are sold, the funds become part of the assets of the recipient, unless there are evident special arrangements between the parties the title of the money will pass to the recipient agent seller. Therefore, even though the sale proceeds are to be used for a specified purpose, such as the purchase of another chattel, this should not on its own be insufficient to create a trust over the funds which favours the owner of the original chattel.

### 3 Review

The express trust has been used in commercial transactions as a highly effective proprietary gateway where the parties in a commercial transaction did not envisage or accept that the debtor would acquire title to the money or the creditor would assume the potential risk of the debtor's insolvency. Here, it is arguable that the trust is not operating in a context where one reposes reliance and confidence in another party - except perhaps where money is transferred for safekeeping. The express trust is a kind of bare trust with limited trustee powers<sup>127</sup> used as a security

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<sup>126</sup> Chapter 4, 173-174.

<sup>127</sup> For a description of the bare trust see Meagher and Gummow, above n 1, [318].

device pursuant to which a commercial party undertakes a risk protection exercise. Thus, the line between the express trust and security devices which commentators insist upon<sup>128</sup> is not so discernible in these kinds of cases.<sup>129</sup>

However, the express trust has its limitations. There must be an intention to create a trust or conduct which manifests an intention to create a trust. Some well advised creditors will insist that written express trusts govern the commercial transactions. However, in many cases, commercial parties will not have the time to seek and implement such a sophisticated security arrangement. Courts will be left with the unenviable task of deciding whether or not the conduct of the parties sufficiently manifests an intention to deal with the transferred funds or sale proceeds contrary to commercial norms. Such an exercise can lead to the distortion of the concept of intention and result in doctrinal confusion. Moreover, not all commercial situations where a trust is claimed to exist can be explained on the basis of an intention (however broadly defined) to create a trust. Indeed, it can be argued that a plaintiff did wish the insolvent to have title to money.

Therefore, other equitable proprietary gateways have been adapted and expanded to meet claims for proprietary relief.

### **III NO EXPRESS INTENTION OR MANIFESTATION OF INTENTION TO CREATE A TRUST**

#### ***A Introduction***

A difficult issue to determine is on what basis courts should intervene in commercial relationships where the parties have not actually intended or manifested an intention to alter commercial norms.

The following discussion highlights various methods which have been employed and suggested to deal with this problem. The advantages and disadvantages of these adaptations are discussed subsequently. It will be quickly appreciated that despite the different approaches which have been used (with varying success), they all have two common threads. First, courts and commentators have

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<sup>128</sup> Edward I Sykes and Sally Walker, *The Law of Securities* (5th ed, 1993) 12.

<sup>129</sup> Bridge, above n 2, 355.

taken traditional approaches to equitable proprietary interests and relief and built upon them. Positively speaking, they have expanded the potential use of these traditional proprietary gateways. However, such an expansion has been made at a price. Thus, the use of equitable proprietary gateways in this way has led to a considerable amount of doctrinal uncertainty. Secondly, the discussion of these proprietary gateways will indicate that risk assumption has been generally overlooked as a criterion, which may determine whether equitable proprietary relief should be available.

## **B Fiduciary Obligations**

The equitable concept of fiduciary obligations has provided a ready gateway to proprietary relief. This is very understandable because the categories of fiduciary obligations are not closed and may arise in a variety of situations outside the standard nominate categories.<sup>130</sup> Fiduciary obligations have been found to exist between a government and indigenous people,<sup>131</sup> bankers and customers,<sup>132</sup> doctors and patients<sup>133</sup> and parents and children.<sup>134</sup> Moreover, there are many cases of which *Re Diplock*<sup>135</sup> is notable, which stand for the proposition that in order to sustain a claim for proprietary relief, a fiduciary relationship must be established.<sup>136</sup> Thus,

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<sup>130</sup> See generally *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41; *LAC Minerals Ltd v International Corona Resources Ltd* (1989) 61 DLR (4th) 14; *Hodgkinson v Simms* [1994] 3 SCR 377; (1995) 117 DLR (4th) 161; *Breen v Williams* (1996) 186 CLR 71, 107 (Gaudron and McHugh JJ).

<sup>131</sup> *Guerin v The Queen* [1984] SCR 335; (1984) 13 DLR (4th) 321; *R. v Sparrow* [1990] 1 SCR 1075; (1990) 70 DLR (4th) 385; *Te Runanga o Wharekauri Rekoho Inc v Attorney-General* [1993] 2 NZLR 301; *Mabo v Queensland (No 2)* 175 CLR 1, 200-205 (Toohey J). For a criticism of the use of fiduciary law in this context see Professor P D Finn, 'The Forgotten Trust: The People and the State' in Malcolm Cope (ed), *Equity: Issues and Trends* (1995) 131, 136-138.

<sup>132</sup> *Commonwealth Bank v Smith* (1991) 102 ALR 453. Note also Finn, above n 17, 11-12.

<sup>133</sup> *Norberg v Wynrib* [1992] 2 SCR 226; (1992) 92 DLR (4th) 449; *McInerney v MacDonald* [1992] 2 SCR 138; (1992) 93 DLR (4th) 415 cf *Breen v Williams* (1996) 186 CLR 71.

<sup>134</sup> *KM v HM* [1992] 3 SCR 6; (1992) 96 DLR (4th) 289; *H v R* [1996] 1 NZLR 299.

<sup>135</sup> [1948] Ch 456.

<sup>136</sup> See for example *Carter v Long & Bisby* (1896) 26 SCR 430; *Re Wayne Coal Co Ltd*; *Schultz's Case* (1920) 55 DLR 327; *Allen v O'Hearn & Co* [1935] 3 DLR 584; affd [1937] AC 213; [1937] 1 DLR 17; *Szczepkowski v Eppler* [1946] 3 DLR 641; *Re The Bergethaler Waisemant*; *Re Fehr* [1947] 2 DLR 234; *Re Hartney Co (1959) Ltd and Freed* (1962) 4 CBR (NS) 71; *Steffanson v Jaasma and Jaasma* [1976] 4 WWR 449.

commentators have tried to discern the essential qualities of this elusive, but powerful, equitable relationship - some more convincingly than others.<sup>137</sup>

However, the problem has been that courts have been more interested in accessing the proprietary potential of fiduciary obligations without attending to the fact that the relationship between the parties did not warrant and could not warrant the imposition of a fiduciary obligation.<sup>138</sup> This has been the case even where, arguably, the plaintiff did not assume the risk of the defendant's insolvency.

In *Sinclair v Brougham* ('*Sinclair*'),<sup>139</sup> which has been overruled by the House of Lords in *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* ('*Westdeutsche*'),<sup>140</sup> a building society received deposits from members and non-members of the society. The deposit was *ultra vires* in relation to non-members. Lord Parker's judgment in this case rested on the recognition of fiduciary obligations existing between depositors of moneys deposited *ultra vires* and the directors of the society. Therefore, he held that the remaining assets were distributable amongst the members and non-members rateably.<sup>141</sup> Lord Parker's 'discovery' of fiduciary obligations in the situation has been queried because it was not clear why the directors owed fiduciary obligations to such depositors.<sup>142</sup> In

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<sup>137</sup> See for example Finn, above n 17, 5; PD Finn, 'The Fiduciary Principle' in T G Youdan (ed), *Equity, Fiduciaries and Trusts* (1989) 1; Austin W Scott, 'The Fiduciary Principle' (1949) 37 *California Law Review* 539; Ernest J Weinrib, 'The Fiduciary Obligation' (1975) 25 *University of Toronto Law Journal* 1; JC Shepherd, 'Towards a Unified Concept of Fiduciary Relationships' (1981) 97 *The Law Quarterly Review* 51; Tamar Frankel, 'Fiduciary Law', (1983) 71 *California Law Review* 795; Tamar Frankel, 'Fiduciary Relationship in the United States Today' in DWM Waters (ed), *Equity, Fiduciaries and Trusts* 1993 (1993) 173; JR Maurice Gautreau, 'Demystifying the Fiduciary Mystique' (1989) 68 *The Canadian Bar Review* 1; John Glover, above n 17, Chapters 1-3; John Glover, 'Wittgenstein and the Existence of Fiduciary Relationships: Notes Towards a New Methodology' (1995) 18 *The University of New South Wales Law Journal* 443; Patrick Parkinson, 'Fiduciary Obligations' in Patrick Parkinson (ed), *The Principles of Equity*, (1996) 325.

<sup>138</sup> See Malcolm Cope, *Proprietary Claims and Remedies* (1997) 99.

<sup>139</sup> [1914] AC 398.

<sup>140</sup> [1996] AC 669, 709-711 (Lord Browne-Wilkinson).

<sup>141</sup> [1914] AC 398, 445-448.

<sup>142</sup> See for example Lord Goff of Chieveley and Gareth Jones, *The Law of Restitution* (4<sup>th</sup> ed, 1993) 84; Meagher, Gummow and Lehane, above n 46, [505]; cf Legatt LJ in *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1994] 1 WLR 938, 953.

comparison, Lord Haldane<sup>143</sup> and Lord Dunedin<sup>144</sup> held that the circumstances had not created such a fiduciary relationship.

The trend to utilise fiduciary obligations as a means of justifying proprietary relief is also illustrated in *Chase Manhattan Bank NA v Israel-British Bank (London) Ltd ('Chase')*.<sup>145</sup> The plaintiff bank paid over \$2 million to another bank in New York for account to the defendant bank which carried on business in London. The defendant went into liquidation and the question was whether the plaintiff could recover \$2 million from the defendant. Goulding J held that the plaintiff could do so where money was paid under factual mistake. He held that the plaintiff retained an equitable proprietary interest in that money and the defendant was subject to a fiduciary duty in respect of the money.<sup>146</sup> In finding that a mistaken payment created a fiduciary relationship between the two banks, Goulding J had given the mistaken payer an opportunity to utilise the traditional tracing rules and recoup the moneys. At the time of the case, the remedial constructive trust was not judicially recognised and utilised in English courts in comparison to their American counterparts.<sup>147</sup> Thus, Goulding J felt compelled to characterise a relationship between two large corporate banks as fiduciary - notwithstanding the fact that there was clearly no duty of loyalty or special relationship of trust and confidence between them. Therefore, it is not surprising that in *Westdeutsche*<sup>148</sup> Lord Browne-Wilkinson reinterpreted the case as an example of the potential operation of the remedial constructive trust.<sup>149</sup>

The existence of fiduciary obligations may also be used to access the rules in *Barnes v Addy*. In such a case, not only is the concept of fiduciary obligations distorted, but the concept of notice is expanded to include notions of constructive

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<sup>143</sup> [1914] AC 398, 421-424.

<sup>144</sup> *Ibid* 436-438.

<sup>145</sup> [1981] Ch 105. See also *English v Dedham Vale Properties Ltd* [1978] 1 All ER 382.

<sup>146</sup> *Ibid* 120; Note also *Goodbody v Bank of Montreal* (1974) 47 DLR (3d) 335.

<sup>147</sup> *Cf Re Berry* 147 F 208 (2<sup>nd</sup> Cir, 1906).

<sup>148</sup> [1996] AC 669.

<sup>149</sup> *Ibid* 714-715.



notice. Here fiduciary obligations are used as a means of re-allocating risk to a third party who has sufficient knowledge of the insolvent's unconscionable conduct.<sup>150</sup>

The attractiveness of a fiduciary characterisation has dimmed in recent years. There are two reasons. First, judges<sup>151</sup> and commentators<sup>152</sup> have drawn attention to this misuse of the fiduciary obligations. In *Breen v Williams*,<sup>153</sup> the High Court of Australia held that whilst a medical practitioner did owe certain equitable obligations to a patient, such a patient could not rely on fiduciary obligations between doctor and patient to access medical records.<sup>154</sup> The patient did not have a proprietary interest in the records and was unable to rely on fiduciary law in order to assert a proprietary interest in them. Gaudron and McHugh JJ also warned against the insensitive overuse of fiduciary obligations:

many of the Canadian cases pay insufficient, if any, regard to the fact that the imposition of fiduciary duties often gives rise to proprietary remedies that affect the distribution of assets in bankruptcies and insolvencies.<sup>155</sup>

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<sup>150</sup> See for example, *Westpac Banking Corporation v Savin* [1985] 2 NZLR 41; *Lankshear v ANZ Banking Group (New Zealand) Ltd* [1993] 1 NZLR 481.

<sup>151</sup> *LAC Minerals Ltd v International Corona Resources Ltd* [1989] 2 SCR 574, 648-652; (1989) 61 DLR (4th) 14, 30-32 (La Forest J); Lord Browne-Wilkinson, 'Equity in a Fast Changing World', *Law Conference 9-13 April, 1996, Dunedin*, 170, 172 - Lord Browne-Wilkinson's statement was quoted in Mr Justice PW Young, 'Current Issues' (1996) 70 *The Australian Law Journal*, 673, 674; *Woodson (Sales) Pty Ltd v Woodson (Australia) Pty Ltd* (1996) 7 BPR 14,685, 14,706-14,708; the dissenting judgment of Meagher JA of the New South Wales Court of Appeal in *Breen v Williams* (1994) 35 NSWLR 522, 570.

<sup>152</sup> For example, Parkinson, above n 137, [1020]; John D McCamus, 'Prometheus Unbound: Fiduciary Obligation in the Supreme Court of Canada' [1997] 28 *Canadian Business Law Journal* 107; Peter Birks, 'Restitutionary Damages for Breach of Contract: *Snepp* and the fusion of law and equity' [1987] *Lloyds Maritime and Commercial Law Quarterly* 421, 436-440; AJ Oakley, *Constructive Trusts* (3<sup>rd</sup> ed, 1997) 99-110.

<sup>153</sup> (1996) 186 CLR 71.

<sup>154</sup> *Ibid* 92-98 (Dawson and Toohey JJ) and 106-114 (Gaudron and McHugh JJ).

<sup>155</sup> *Ibid* 113.

This has resulted in the Court adopting a proscriptive approach rather than the wider prescriptive approach which is dominant in Canada,<sup>156</sup> particularly where the concept of fiduciary obligations is used to access property rights.

Secondly, in the light of the doctrinal difficulties, the imposition of the remedial constructive trust has support at various levels in a number of jurisdictions. In the United States it can be said that the remedial constructive trust was embraced earlier than in other common law jurisdictions. The imposition of the constructive trust was not always predicated on the existence of a pre-existing fiduciary obligation. Rather, it arose and still arises in response to certain kinds of events such as theft,<sup>157</sup> misrepresentation<sup>158</sup> and mistake.<sup>159</sup> The general scenario appears to be that the party is able to factually trace the funds. Thereafter, a constructive trust is imposed upon the funds.<sup>160</sup> In contradistinction, the situation in *Chase*<sup>161</sup> was quite different. The fiduciary obligation was imposed in order to enable the payer to access tracing and the proprietary remedy of the institutional constructive trust. The former situation represents an extension of the constructive trust beyond its institutionalised bounds. The latter situation was simply a creation of a fictional pattern which reflected and superficially conformed to traditional norms. In recent times, the Canadian courts have rejected the necessity of a pre-existing fiduciary obligation in favour of the remedial constructive trust.<sup>162</sup> This trend has become apparent in

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<sup>156</sup> Note *Frame v Smith* [1987] 2 SCR 790; (1987) 42 DLR (4th) 81. For a helpful discussion of the differences between the proscriptive and the prescriptive approaches see Patrick Parkinson, 'Fiduciary Law and Access to Medical Records: *Breen v Williams*' [1995] 17 *The Sydney Law Review* 432, 440-443.

<sup>157</sup> *Peters v Carr* 654 SW (2d) 317 (Mo App, 1983). In relation to embezzling agents see *Mickelson v Barnet* 460 NE (2d) 566 (Mass SC, 1984). See generally 89 CJS Trusts § 146.

<sup>158</sup> *Scheidelman v Castle* 496 NYS (2d) 111 (SC, 1985). In relation to fraud and misrepresentation see Scott and Fratcher above n 7, vol V § 468-471 and 89 CJS Trusts § 145-146.

<sup>159</sup> *Lamkin v Hill* 419 A (2d) 1077 (SC New Hampshire, 1980) 1; *Re Mahan & Rowsey Inc* 817 F (2d) 682 (10<sup>th</sup> Cir, 1987). In relation to mistake see Scott and Fratcher above n 7, vol V § 465-467, § 472-473 and 89 CJS Trusts § 143.

<sup>160</sup> See Meagher and Gummow, above n 1, [1310].

<sup>161</sup> *Chase Manhattan Bank NA v Israel-British Bank (London) Ltd* [1981] Ch 105.

<sup>162</sup> See generally *Pettkus v Becker* [1980] 2 SCR 834; (1980) 117 DLR (3d) 257. Note also *Simpson-Sears Ltd v Fraser* (1974) 54 DLR (3d) 225; *BC Teachers' Credit Union v Betterly* (1975) 61 DLR (3d) 755. For a good general discussion see Peter D Maddaugh and John D McCamus, *The Law of Restitution* (1990) 140-141. In relation to fraud see *Re Blackhawk Downs Inc and Arnold* (1972) 38 DLR (3d) 75.

Australia as well.<sup>163</sup> In England, there is authority which suggests that the constructive trust was available to remedy fraud without the necessity for a pre-existing fiduciary obligation.<sup>164</sup> Moreover, it is clear that the analysis provided by Goulding J in *Chase* has been rejected by the House of Lords,<sup>165</sup> and the remedial constructive trust could become a carefully utilised device.<sup>166</sup> This is discussed below.<sup>167</sup>

Therefore, the use of fiduciary obligations as a means of justifying a proprietary result is no longer acceptable. It is a fiction because in some cases there is no relationship of trust or confidence. Courts are able to sidestep (or limit) discussion of the fundamental issue of why proprietary relief should be countenanced in a debtor-creditor relationship.

The traditional veneer has another unwelcome effect. Because the cases which utilise the fiduciary obligation in this fashion, do not in fact fall within general doctrine or academic theory of fiduciary obligations they are treated as odd or unusual.<sup>168</sup> Thus, they are relegated to a discussion of atypical or singular applications of fiduciary obligations. Yet, these cases are neither unusual nor singular. In truth, they represent a growing trend in which courts exercising equitable jurisdiction have been and are willing to intervene in commercial relationships in certain circumstances and on certain conditions. By explaining the cases as examples of unusual fiduciary obligations, the courts have not only utilised an inappropriate proprietary gateway, but they have unnecessarily concealed what is happening in our legal system.

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<sup>163</sup> *Muschinski v Dodds* (1986) 160 CLR 583. Note also *Australian Postal Corporation v Lutak* (1991) 21 NSWLR 584; *Zobory v Federal Commissioner of Taxation* (1995) 129 ALR 484, 487; *Rasmanis v Jurewitsch* (1970) 70 SR (NSW) 407 and Cope, above n 138, Chapter 4.

<sup>164</sup> Maddaugh and McCamus, above n 162, 86-87; DWM Waters, *The Constructive Trust: The Case for a New Approach in English Law* (1964) 55-57.

<sup>165</sup> *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669, 715 (Lord Browne-Wilkinson).

<sup>166</sup> *Ibid* 716 (Lord Browne-Wilkinson).

<sup>167</sup> Below, 129-132.

<sup>168</sup> See for example Meagher, Gummow and Lehane, above n 46, [505]; Parkinson, above n 137, [1020].

## *C Resulting Trusts*

Another traditional proprietary gateway is the resulting trust. The situations where a resulting trust arises has been discussed elsewhere.<sup>169</sup> It will be recalled that one of the interpretations of the resulting trust is that it is based on an absence of intention to vest the beneficial interest in the recipient of the property. This definition has formed the foundation of an attempt to expand and utilise the resulting trust as the dominant proprietary device which would regulate commercial transactions in insolvency situations. The nucleus of this idea was formulated by Birks<sup>170</sup> and was later refined by Chambers.<sup>171</sup>

The utilisation of the resulting trust has been more discernible in England than in other jurisdictions such as Australia.<sup>172</sup> No doubt also, Birks and Chambers have been influenced by Viscount Haldane LC in *Sinclair*.<sup>173</sup> Although, Viscount Haldane's reasons for finding that a proprietary interest existed is far from clear,<sup>174</sup> he held that a resulting trust vested the equitable interest in the depositors.<sup>175</sup> Chambers has stated:

The role of intention in resulting trusts is a negative one. The primary question is always whether the provider intended to benefit the recipient and not whether he or she intended to create a trust. The latter question is relevant, of course, to whether the provider has succeeded in creating an express trust, but its relevance to the resulting trust is only as an indication of a lack of intention to benefit the recipient. Although a resulting trust may be identical to an express trust which the provider intended, but failed, to create, this is

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<sup>169</sup> Chapter 2, 56-60.

<sup>170</sup> Peter BH Birks, 'Restitution and Resulting Trusts' in Stephen Goldstein (ed), *Equity and Contemporary Legal Developments* (1992) 335.

<sup>171</sup> Chambers, above n 89. Note also in this context Helen Norman, 'Tracing the Proceeds of Crime: an Inequitable Solution?' in Peter Birks (ed), *Laundering and Tracing* (1995) 95, 102 and Worthington, above n 5, Chapter 7.

<sup>172</sup> *Pettit v Pettit* [1970] AC 777; *Gissing v Gissing* [1971] AC 886; Waters, above n 1, 357-361.

<sup>173</sup> [1914] AC 398.

<sup>174</sup> *Re Diplock* [1948] Ch 465, 540-541; Chambers, above n 89, 156-157; Goff and Jones, above n 142, 83-84.

<sup>175</sup> *Sinclair v Brougham* [1914] AC 398, 421.

fortuitous because the facts which gave rise to a resulting trust and define its content (the unjust enrichment of the recipient) are different from those which create and define an express trust (the intentional actions of the settlor).<sup>176</sup>

In so arguing, Chambers has made a number of assumptions about the nature of intention, traditional resulting trusts, the nexus between the resulting trust and the law of restitution and the nature of commercial relationships.

First, Chambers relied on a notion of intention which is difficult to define. It may be a difficult task to confirm that there has been an *absence* of intention where the factors which may give rise to intention are broad and varied. It is also conceptually unsatisfying to develop a trust regime in which trusts arise by virtue of intention to retain an equitable interest and by virtue of an *absence* of intention to transfer title to money.

Secondly, even if the concept of absence of intention was accepted as the qualifying factor, it was by no means clear that the traditional resulting trust was always based on the absence of intention. There have been other interpretations of the conceptual *raison d'être* of the resulting trust such as what is the presumed intention of a party<sup>177</sup> or the common intention of the parties.<sup>178</sup> Moreover, there are many cases which Chambers located as examples of a resulting trust operating sometimes in a disguised fashion, which can be explained satisfactorily on the basis of other equitable principles such as undue influence (or duress),<sup>179</sup> or mutual intention to create an express trust.<sup>180</sup>

Thirdly, a strict application of the absence of intention test does not provide the proprietary tool for which Chambers hoped. Chambers has argued that a wide range of situations where there has been vitiated intention (such as where there is a

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<sup>176</sup> Chambers, above n 89, 222.

<sup>177</sup> *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669, 708 (Lord Browne-Wilkinson).

<sup>178</sup> *Pettit v Pettit* [1970] AC 777; *Gissing v Gissing* [1971] AC 886; *Calverley v Green* (1984) 155 CLR 242, 251 (Gibbs CJ); Waters, above n 1, 357-361; cf Chambers, above n 89, 36.

<sup>179</sup> See the cases discussed in Chambers, above n 89, 139-142.

<sup>180</sup> See generally Part II of this Chapter.

mistake)<sup>181</sup> or qualified intention (or intention conditioned on the happening of events which do not occur)<sup>182</sup> can be explained on the basis of an absence of intention to benefit the other party. Yet, this is far from an accurate understanding of the situation. When a party transfers money to another on the basis of a mistake which is discovered later, that party generally intends to transfer title to the transferees. It has been this point in relation to intention that Chambers' thesis has unravelled.

Fourthly, Chambers co-joined the operation of the resulting trust and the law of restitution (or more properly subtractive enrichment). He argued that the resulting trust and the law of restitution historically followed a similar trend, namely,<sup>183</sup>

the recognition of unjust enrichment as the generic event to which the common law obligation and the resulting trust each respond.<sup>184</sup>

In a seminal article on the resulting trust, Swadling argued convincingly that the resulting trust had little historical relationship with the law of restitution. He pointed out that the absence of intention was not the critical factor which underlined or ought to underline equitable intervention where the law of restitution is concerned.<sup>185</sup>

Swadling's concerns were reviewed in *Westdeutsche*.<sup>186</sup> The plaintiff bank and the defendant local authority entered into a ten year interest rate swap.<sup>187</sup> Under the swap, interest payments were payable on a half yearly basis and the plaintiff agreed to pay the local authority a lump sum of £2.5 million as the first fixed rate payment. The local authority made a series of payments. It was held in earlier decisions that it was beyond the power of local authorities to enter into interest rate

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<sup>181</sup> Chambers, above n 89, 125-132.

<sup>182</sup> Ibid Chapter 6.

<sup>183</sup> Ibid 223.

<sup>184</sup> Ibid.

<sup>185</sup> William Swadling, 'A New Role for Resulting Trusts?' (1996) 16 *Legal Studies* 110. Note also Andrew Burrows, 'Swaps and the Friction between Common Law and Equity' [1995] *Restitution Law Review* 15.

<sup>186</sup> [1996] 2 AC 669.

<sup>187</sup> For a discussion of interest rate swaps see Nasser Saber, *Interest Rate Swaps: Valuation, Trading and Processing* (1994); Clive Grumball, *Managing Interest Rate Risk* (1987) Chapter 3.

swap arrangements. Such an agreement was ultra vires their powers.<sup>188</sup> The plaintiff bank, having recovered an amount which represented the initial payment less the amounts paid by the local authority, sought to recover compound interest on that sum. The trial judge held that the bank was entitled to do so<sup>189</sup> and the Court of Appeal dismissed the appeal of the local authority.<sup>190</sup> Dillon LJ held that a resulting trust operated<sup>191</sup> and the appropriate award was compound interest.<sup>192</sup>

The House of Lords reversed the decision of the Court of Appeal. It held that the plaintiff had only a personal action based on total failure of consideration and it was not appropriate for the bank to obtain compound interest.<sup>193</sup> Some of Lord Browne-Wilkinson's objections to the operation of the resulting trust were based on broader notions of how trusts work. These are considered below.<sup>194</sup> However, he endorsed Swadling's contention that a presumption of a resulting trust was rebuttable by any inconsistent intention.<sup>195</sup> Lord Goff (who dissented in relation to other matters) accepted Lord Browne-Wilkinson's view that the imposition of the resulting trust was inconsistent with traditional trust principles.<sup>196</sup> Moreover, Lord Goff opined that in such ultra vires cases, there was a clear intention at the time the transaction took place, that the title to the money should pass to the recipient.<sup>197</sup> It can be added that the general nature of money as a negotiable commodity<sup>198</sup> necessitated the conclusion that title to the money passed to the recipient.

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<sup>188</sup> See for example, *Hazell v Hammersmith and Fulham London Borough Council* [1992] 2 AC 1.

<sup>189</sup> *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* (1993) 91 LGR 323.

<sup>190</sup> *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1994] 1 WLR 938.

<sup>191</sup> *Ibid* 947; cf the judgement of Legatt LJ at 952-953 based on fiduciary obligations.

<sup>192</sup> *Ibid* 948-951 (Dillon J); 953-955 (Legatt LJ).

<sup>193</sup> *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669, 717 (Lord Browne-Wilkinson).

<sup>194</sup> Below, 129-131.

<sup>195</sup> [1996] AC 669, 708, 716.

<sup>196</sup> *Ibid* 689-690.

<sup>197</sup> *Ibid*.

<sup>198</sup> Chapter 1, 12-13.

Fifthly, just as Chambers embraced the concept of the absence of intention as the underlying and infusing equitable intervention, Chambers has rejected serious consideration of the other explanations for the intervention of equity. He dismissed (too swiftly in the author's opinion) the notion of the assumption risk as the central factor which should be considered when considering the intervention of equity in commercial transactions.<sup>199</sup> He also rejected considerations of whether at the time of the transaction, there was evidence of the recipient's imminent insolvency.<sup>200</sup>

Finally, Chambers' theory was used to explain such situations as where there was a mistaken payment,<sup>201</sup> ultra vires transactions<sup>202</sup> or failure of consideration.<sup>203</sup> However, he faced difficulties applying the resulting trust to situations which he identified as wrongs, most notably the wrongful conduct of the trustee such as in the making of an unauthorised profit.<sup>204</sup> He argued that these situations do not attract the resulting trust. Rather, the wrong was the primary event and the response is the institutional constructive trust.<sup>205</sup> In this respect, Chambers' topography reflected Birks' work in the area.<sup>206</sup> The consequence of the approach was that Chambers has created a bifurcated system of trusts based on whether the circumstances were unjust enrichment by subtraction or wrongdoing.

The problem with Chambers' approach was that he failed to appreciate that the concept of 'wrongdoing' or unconscionable conduct has always been broad and has broadened in recent decades to encompass the wrongful retention of money outside breaches of fiduciary obligations.<sup>207</sup> Therefore, the concept of

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<sup>199</sup> Chambers, above n 89, 235.

<sup>200</sup> Ibid 236.

<sup>201</sup> Ibid 125-132.

<sup>202</sup> Ibid 123-125.

<sup>203</sup> Ibid 154-163.

<sup>204</sup> Ibid 230.

<sup>205</sup> Ibid.

<sup>206</sup> See for example Birks, above n 170.

<sup>207</sup> See Chapter 5, 189-193.



unconscionable conduct encompasses the traditional area of common law counts for money had and received<sup>208</sup> and the kinds of cases which has Chambers discussed.

### **D Subrogation**

Connected with the view that the way to solve proprietary problems is to utilise pre-existing legal mechanisms, has been the suggestion that there is scope for the development of a broadened notion of subrogation. This suggestion has arisen in the context of the possible proprietary mechanisms which are open to plaintiffs bringing an action based on restitution. This is another example of an attempt to appropriate an equitable mechanism with proprietary effect to the armoury of restitution.<sup>209</sup>

Mitchell has advanced the most comprehensive thesis in this regard.<sup>210</sup> He has argued that there are two forms of subrogation.<sup>211</sup> There is simple subrogation. This kind of subrogation operates to transfer subsisting rights of action from one party to another such as in insurance cases.<sup>212</sup> The second form of subrogation is 'reviving' subrogation. In this situation, a third party makes a payment to the security holder which discharges the security. However, the security 'revives' in response to unjust enrichment in such situations as legal compulsion, in which the party which was primarily liable has obtained a benefit at the expense of a third party.<sup>213</sup>

In *Banque Financière de la Cité v Parc (Battersea) Ltd* ('*Banque Financière*')<sup>214</sup> the House of Lords endorsed the operation of subrogation as a restitutionary remedy. What essentially occurred was that the plaintiff lender paid out, in part, the obligations the defendant owed to a first chargee. The plaintiff did not contemplate that the defendant would provide security. However, the plaintiff did

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<sup>208</sup> *Muschinski v Dodds* (1986) 160 CLR 583, 619-620 (Deane J).

<sup>209</sup> See Peter Birks, *An Introduction to the Law of Restitution* (1985) 93-98; Andrew Burrows, *The Law of Restitution* (1993) 76-93.

<sup>210</sup> Charles Mitchell, *The Law of Subrogation* (1994).

<sup>211</sup> *Ibid* 5.

<sup>212</sup> *Ibid* Chapter 6.

<sup>213</sup> *Ibid* 10-11.

<sup>214</sup> [1998] 2 WLR 475.

obtain a letter by the corporate group's general manager that the groups would not demand repayment of loans made to the borrowing company until the plaintiff was paid out. Another company in the group, Omnicorp Overseas Ltd ('OOL') was a second chargee. The group collapsed. The question was whether, as against OOL, the plaintiff had an effective proprietary interest. The House of Lords held that subrogation was a remedial response to unjust enrichment. It was clear that there was no common intention between OOL and the defendant that OOL would access the pre-existing security.<sup>215</sup> But, this did not preclude subrogation being used as a restitutionary remedy.<sup>216</sup> OOL would be unjustly enriched if it were permitted to take priority over the plaintiff. The plaintiff had made the repayment on the mistaken belief that it would take priority over all other members of the corporate group.<sup>217</sup> Lord Hoffman said:

subrogation is not a right or cause of action but an equitable remedy against a party who would otherwise be unjustly enriched. It is a means by which the court regulates the legal relationships between a plaintiff and a defendant or defendants in order to prevent unjust enrichment. When judges say that the charge is 'kept alive' for the benefit of the plaintiff, what they mean is that his legal relations with a defendant who would otherwise be unjustly enriched are regulated *as if* the benefit of the charge had been assigned to him. It does not by any means follow that the plaintiff must for all purposes be treated as an actual assignee of the benefit of the charge and, in particular, that he would be so treated in relation to someone who would not be unjustly enriched.<sup>218</sup>

In effect, an in personam action gave rise to an in personam remedy which had a proprietary effect.<sup>219</sup>

However, the potential utilisation of subrogation is limited. It must not be forgotten that the traditional view is that a party only acquires rights to which the paid out party is entitled. If there is no pre-existing security, then it is difficult to

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<sup>215</sup> Ibid 483 (Lord Hoffman with whom Lord Steyn, Lord Griffiths and Lord Clyde agreed).

<sup>216</sup> Ibid 483-485 (Lord Hoffman).

<sup>217</sup> Ibid 486 (Lord Hoffman).

<sup>218</sup> Ibid 487-488 (Lord Hoffman).

<sup>219</sup> Ibid 480 (Lord Steyn).

argue that the doctrine of subrogation will operate. In *Banque Financière*,<sup>220</sup> the pre-existing charge was an important factor in utilising subrogation. Thus, if there had been no charge, but simply a letter, the plaintiff would not have acquired personal relief against OOL with proprietary consequences. Here, it appears odd that the pre-existence of a security was crucial in determining whether the plaintiff was entitled to proprietary relief.

Moreover, subrogation operates in those commercial situations where a party pays out the debts or liabilities of another. In any form, whether the traditional approach or Mitchell's expanded version, it will not assist in bilateral commercial situations. Therefore, there is the possibility that a proprietary topography could develop based on resulting trusts for bilateral commercial relationships and on subrogation based for trilateral relationships. The ultimate issue will be - whether it is necessary to utilise these separate equitable devices to deal with these different situations? It is arguable that to do so would create unnecessary confusion.

### ***E The Constructive Trust - An Approach Based on a Tainted Conscience***

The final adaptation of the equitable devices considered in the previous chapter is the constructive trust based on a tainted conscience. The institutional constructive trust<sup>221</sup> developed as a response to the breach of fiduciary obligations,<sup>222</sup> knowing receipt of trust property<sup>223</sup> or knowing assistance in the breach of fiduciary duty.<sup>224</sup> In each of these cases, the tainted conscience of the wrongdoer has been an instrumental factor giving rise to the imposition of the constructive trust.

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<sup>220</sup> [1998] 2 WLR 475.

<sup>221</sup> Chapter 2, 64.

<sup>222</sup> See generally Barbara McDonald, 'Constructive Trusts' in Patrick Parkinson (ed) *The Principles of Equity* (1996) 709, [2110]-[2120].

<sup>223</sup> *Barnes v Addy* (1874) LR 9 Ch App 244; McDonald, above n 222, [2129]-[2132]; Meagher and Gummow, above n 1, [1333]-[1338].

<sup>224</sup> *Barnes v Addy* (1874) LR 9 Ch App 244; *Consul Development Pty Ltd v DPC Estates Pty Ltd* (1975) 132 CLR 373; *Royal Brunei Airlines Sdn Bhd v Tan* [1995] AC 378; McDonald, above n 222, [2133]-[2137].

In *Westdeutsche*,<sup>225</sup> Lord Browne-Wilkinson set out what he considered to be the basis upon which equity operated:

(i) Equity operates on the conscience of the owner of the legal interest...

(ii) Since the equitable jurisdiction to enforce trusts depends upon the conscience of the holder of the legal interest being affected, he cannot be a trustee of the property if and so long as he is ignorant of the facts alleged to affect his conscience, ie until he is aware that he intended to hold the property for the benefit of others in the case of an express or implied trust, or, in the case of a constructive trust, of the factors which are alleged to affect his conscience.<sup>226</sup>

He held that a constructive trust may arise when the conscience of the recipient is tainted at the time of the receipt or soon after the receipt. However, in *Westdeutsche* a constructive trust had not arisen. At the time of the receipt of the funds which were the subject of the swap agreement, the council was not aware that the swap was ultra vires its powers. Moreover, he overruled *Sinclair*<sup>227</sup> and explained *Chase*<sup>228</sup> on the basis that whilst the bank did not know of the mistaken payment at the time of receipt, it became aware of the mistake two days afterwards.<sup>229</sup> Thereafter, Lord Browne-Wilkinson described the future remedial constructive trust in the following terms:

Although the resulting trust is an unsuitable basis for developing proprietary restitutionary remedies, the remedial constructive trust, if introduced into English law, may provide a more satisfactory road forward. The court by way of remedy might impose a constructive trust on a defendant who knowingly retains property of which the plaintiff has been unjustly deprived. Since the remedy can be tailored to the circumstances of the particular case, innocent third parties would not be prejudiced and restitutionary defences, such as change of position, are capable of being given effect.<sup>230</sup>

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<sup>225</sup> [1996] AC 669.

<sup>226</sup> Ibid 705.

<sup>227</sup> Ibid 710.

<sup>228</sup> Ibid 715.

<sup>229</sup> Ibid.

<sup>230</sup> Ibid 716; see also Cope, above n 138, 94-95.

In addition, Lord Browne-Wilkinson emphasised the need for specifically identifiable property. This issue is considered in Chapter 4.<sup>231</sup>

Lord Browne-Wilkinson's approach to the problem he faced in *Westdeutsche* is understandable in the light of equitable jurisprudence, even if ultimately, it is flawed and impractical. He drew on a tradition of equity which does constrain parties who have knowledge of factors which should affect their conscience.<sup>232</sup> The tradition is a strong one and sustains such principles as breach of fiduciary obligations,<sup>233</sup> the rules in *Barnes v Addy*,<sup>234</sup> unconscionable dealings<sup>235</sup> and undue influence.<sup>236</sup> However, his interpretation of the concept of unconscionable conduct was unduly narrow and did not accord with the way in which equity has developed. Suffice to say at this stage, that the concept of unconscionable conduct (or unjust enrichment which has been developed in other jurisdictions) has taken into account not only whether there was a tainted conscience at the commencement of the transaction and receipt of funds, but also whether there are intervening circumstances which lead to the conclusion that it is improper for the recipient to retain them.<sup>237</sup> Understandably,

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<sup>231</sup> Ibid 705.

<sup>232</sup> See for example *Nocton v Lord Ashburton* [1914] AC 932, 954 (Viscount Lord Haldane); *National City Bank v Gelfert* 29 NE (2d) 449, 452; 130 ALR 1472, 1475 (Court of Appeals, New York, 1940); Patrick Parkinson, 'The Conscience of Equity' in Patrick Parkinson (ed), *The Principles of Equity* (1996) 28.

<sup>233</sup> See for example, *Chan v Zacharia* (1984) 154 CLR 178, 198-199 (Deane J); *Re Taylor; Hewitt v The Union Trustee Company of Australia Ltd* [1950] VLR 476, 479-481 (Herring CJ).

<sup>234</sup> (1874) LR 9 Ch App 244; *Consul Development Pty Ltd v DPC Estates Pty Ltd* (1975) 132 CLR 373; *Stephens Travel Service International Pty Ltd (Receivers and Managers Appointed) v Qantas Airways Ltd* (1988) 13 NSWLR 331; *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 378.

<sup>235</sup> *Wilton v Farnworth* (1948) 76 CLR 646; *Blomley v Ryan* (1956) 99 CLR 362; *Commonwealth Bank of Australia Ltd v Amadio* (1983) 151 CLR 447; *Akins v National Australia Bank* (1994) 34 NSWLR 155; *Vital Finance Corporation Pty Ltd v Taylor* (1991) ASC 56-009; cf *Hart v O'Connor* [1985] AC 1000.

<sup>236</sup> *Earl of Chesterfield v Janssen* (1751) 2 Ven Sen 124; 28 ER 82; *Johnson v Buttress* (1936) 56 CLR 113; *Union Fidelity Co of Australia v Gibson* [1971] VR 573; *Bank of Credit & Commerce International SA Aboody* [1990] 1 QB 923; *Barclays Bank plc v O'Brien* [1994] AC 180.

<sup>237</sup> See for example, for Australia: *Muschinski v Dodds* (1986) 160 CLR 583, 619-620 (Deane J) and *Linsley v Petrie* [1998] 1 VR 427, 446 (Callaway JA); for Canada *Pettikus v Becker* [1980] 2 SCR 834; (1980) 117 DLR (3d) 257 and the United States of America: American Law Institute, *Restatement of the Law of Restitution, Quasi Contracts and Constructive Trusts* (1937) § 160.

restitution lawyers who seek to link the law restitution to proprietary relief have criticised the judgement of Lord Browne-Wilkinson as well.<sup>238</sup>

Another practical criticism of the judgment is the temporal limitation on the effectiveness of the knowledge requirement. The reason for this approach is to ensure that there is stability in commercial dealings and that a plaintiff does not acquire a proprietary interest months, and sometimes years, after the happening of the event. A more appropriate manner of dealing with the situation would be to permit actions untrammelled by considerations of time. However, an action would be subject to an equitable defence of laches.<sup>239</sup>

The judgment of Lord Browne-Wilkinson in *Westdeutsche* represented an unpolished response to the issue of proprietary interests in commercial non-fiduciary relationships. The emphasis on the conscience of the defendant solely at the time of receipt did not encompass the broadened concept of unconscionable conduct which is alive in equity jurisprudence today. Equally, it did not identify and apply an underlying modern criterion for equitable intervention - whether the plaintiff assumed the risk of being an unsecured creditor.

#### IV CONCLUSION - LIMITATIONS OF THE ADAPTATION OF EXISTING MECHANISMS

The previous discussion has highlighted the problems which have arisen in relation to the adaptation, or proposed adaptation, of traditional proprietary gateways to accommodate new situations which arise in commercial relationships. In each of the situations, the difficulties which have arisen have included the stretching of criteria (arguably beyond recognition) in the case of intention to create an express trust, distortion of traditional doctrines, such as in the case of fiduciary obligations and the advocacy of the use of a proprietary mechanism beyond its original application, such as in the case of the resulting trust.

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<sup>238</sup> Peter Birks, 'Equity in the Modern Law: An Exercise in Taxonomy' (1996) 26 *The University of Western Australia Law Review* 1, 92-96; Peter Birks, 'Trusts Raised to Reverse Unjust Enrichment: The *Westdeutsche* Case' [1996] *Restitution Law Review* 3; Chambers, above n 89, 157-163; Worthington, above n 5, Addendum, vii-xxiv.

<sup>239</sup> *Lindsay Petroleum Co v Hurd* (1874) LR 5 PC 221; *Orr v Ford* (1989) 167 CLR 316. For a discussion of the modern law of laches see Michael Spence, 'Equitable Defences' in Patrick Parkinson (ed), *The Principles of Equity* (1996) 939, [2918]-[2926].

However, the most severe criticism must be reserved for the bases for equitable intervention in Part III. Each demonstrates a limited understanding of the fundamental nature of equity and when equity will intervene in commercial relationships. The implementation and advocacy of these gateways has been at the expense of an appreciation of what the concept of unconscionability means. In the case of the extended application of fiduciary obligations, subrogation and resulting trusts, the fundamental concept of unconscionability has been essentially ignored. In the *Westdeutsche* case, the concept of unconscionable conduct was narrowly construed. Without an appreciation of the concept of unconscionability, the development of equitable proprietary intervention will remain unsatisfactory.

There has been insufficient acknowledgment that equity is being asked to intervene in what are essentially commercial transactions. If the notion of lack of risk assumption can be used to explain equitable intervention in undue influence cases, fiduciary obligations, express trusts and subrogation, it is possible that the risk assumption can determine and justify equitable intervention in other commercial situations.

Before discussing assumption of risk further, it is necessary to consider the second factor which has muddied the proverbial waters. When undertaking the adaptation and extension of equitable proprietary gateways, courts and commentators have insisted on a pre-existing proprietary base. In the following chapter, the effect of the specific asset requirement and the breakdown of the requirement will be examined. It will be argued that the specific asset requirement is no longer a helpful or constructive measure of equitable intervention.

## **Chapter 4**

### **FROM THE PROPRIETARY BASE REQUIREMENT TO THE SWOLLEN ASSETS THEORY**



## I INTRODUCTION

The discussion in the preceding chapters has shown that equity has developed a number of proprietary mechanisms some of which have been adapted for the primary purpose of utilising their proprietary and security function.

Apparently, common to the operation of these mechanisms has been the pre-existence of specific property or a proprietary base. The argument is that without the existence of the proprietary base, there is no proprietary interest in or over property. This proposition is very attractive - if only superficially so. After all, how can one have a proprietary interest in property which is neither specific nor ascertainable? It just does not stand up to logic. Therefore, the pre-existence of a proprietary base which encapsulates specific assets is absolutely necessary as a pre-condition for proprietary relief.

The problem with this approach is that there has been a considerable over-emphasis on the practical need for a proprietary base at the expense of determining the underlying rationale for equitable intervention. Instead, it has been shown that assumption of risk is becoming the primary criterion for equitable intervention in commercial situations. Co-existent with the ascendancy of the assumption of risk, the need for a proprietary base is undergoing considerable re-adjustment. Thus, there is a slow, but evident, move away from the requirement of a proprietary base to an evaluation of whether a party could be expected to assume the risk of being an unsecured creditor.

## II PROPRIETARY BASE THEORY

The basic proposition of proprietary base theory is that a plaintiff must be able to point to the asset in dispute in a segregated, substituted or intermixed form. Birks states in relation to restitution:

The only satisfactory basis for raising a restitutionary proprietary right in the assets in which, by substitutions and intermixtures, the original enrichment now survives is as follows: the circumstances of the original receipt by the defendant must be such that, either at law or in equity, the plaintiff retained or obtained the property in the matter received by the defendant, and then continued to retain it until the moment at which the substitution or intermixture took place...where the defendant receives an enrichment which, apart from the substitutions and intermixtures, would have continued to belong to the plaintiff, the law can raise a new restitutionary right *in rem* in the

different assets in which the original receipt is represented at the time of the claim...The phrase 'proprietary base' is used to capture this idea: if he wishes to assert a right *in rem* in the surviving enrichment, the plaintiff must show that at the beginning of the story he had a proprietary right in the subject-matter, and that nothing other than substitutions or intermixtures happened to deprive him of that right *in rem*.<sup>1</sup>

This view has had considerable support.<sup>2</sup> The proprietary base theory has merit because it requires the plaintiff to prove continued existence of the asset (in whatever form) which is subject of the dispute. Therefore, arguably, it creates a degree of legal certainty.

However, in creating such certainty, the proprietary base theory (particularly in extreme versions) has emphasised that the finding of the proprietary base (via common following and tracing rules in particular) is simply a mechanical process to find the 'thing'. Smith has stated that

even though legal rules are inevitably involved, the exercise of tracing is nonetheless just that: an exercise or process which is preliminary to the making of the claim. An analogy may be drawn with a plaintiff who wishes to prove a claim in breach of contract. Such a plaintiff must show that there was a contract. This is done by proving certain facts, such that the application to those facts of the rules of contract formation leads to the conclusion that a contract was formed. Proving that a contract was formed is not a right, nor a remedy; it does not establish liability. It is just something which one is at liberty to do. But some causes of action, such as the one for breach of contract, depend on the successful exercise of that liberty.<sup>3</sup>

Such an argument is unconvincing. Even the most mechanical legal process is motivated by and contains inherent values. In the case of equitable tracing, the values

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<sup>1</sup> Peter Birks, *An Introduction to the Law of Restitution* (1985) 378-379.

<sup>2</sup> See for example RM Goode, 'The Right to Trace and Its Impact in Commercial Transactions' (1976) 92 *The Law Quarterly Review*, 359 and 528; RM Goode, 'Property and Unjust Enrichment' in Andrew Burrows (ed), *Essays on the Law of Restitution* (1991) 215; Robert Chambers, *Resulting Trusts* (1997) 146-147, 234; Lionel D. Smith, *The Law of Tracing* (1997) 300; Malcolm Cope, *Proprietary Claims and Remedies* (1997) Chapter 2. Note also the reasoning and outcome in *Mac-Jordan Construction Ltd v Brookmount Erostin Ltd (In Receivership)* [1992] BCLC 350.

<sup>3</sup> Smith, above n 2, 11; see also *Boscawen v Bajwa* [1996] 1 WLR 328, 334 (Millett LJ).

are open and transparent - the protection of parties who repose trust and confidence and do not assume the risk of the fiduciary's wrongdoing.<sup>4</sup> It is submitted that the reason why the characterisation of equitable tracing as a process is attractive to Smith is that he is able to disengage tracing from its essentially equitable origins and portray it as a neutral and non-equitable exercise. He argues, inter alia, that the pre-existence of fiduciary relationship is not necessary to utilise tracing.<sup>5</sup> Smith redefines tracing as essentially a common law process with proprietary consequences which is available to redress unjust enrichment (restitutionary claims) and wrongdoing.<sup>6</sup> Thus, Smith re-attaches the equitable tracing process to claims and causes of action which essentially conform to Birks' topology of restitution.<sup>7</sup> Whilst this is a convenient outcome for restitution lawyers, it is an inaccurate picture of equitable tracing as a response to fiduciary wrongdoing. This is symptomatic of the attempts of restitution lawyers to appropriate equity's proprietary mechanisms as remedies for personal actions.<sup>8</sup>

### III MECHANICAL PROCESS UNDER TRANSITION

#### *A Introduction*

Increasingly, the capacity to meet the proprietary base requirement is becoming more difficult. Therefore, a trust application of the proprietary base requirement has been relaxed in the light of the fungible nature and negotiable function of money. For example, equity has loosened its interpretation of the well known requirement that in trust law there must be certainty of subject matter.<sup>9</sup> The criterion is satisfied where a declaration of trust is made in respect of a portion of

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<sup>4</sup> For example, *Australian Securities Commission v Melbourne Asset Management Nominees Pty Ltd* (1994) 49 FCR 334.

<sup>5</sup> Smith, above n 2, 120-130.

<sup>6</sup> Ibid 291-299.

<sup>7</sup> Birks, above n 1, 106-107.

<sup>8</sup> See generally, Chapter 3.

<sup>9</sup> *Knight v Knight* (1840) 3 Beav 148; 49 ER 58.

shares which are fungible<sup>10</sup> or where there is an express written intention to create a trust without any requirement to segregate funds in a separate bank account.<sup>11</sup>

An analysis of recent decisions on common law following and equitable tracing best illustrates the erosion of proprietary base theory.

## ***B Following and Tracing***

The requirement for the identifiability of a res (an inherently common law requirement)<sup>12</sup> began to break down when the bases for both the common law and equitable tracing rules were developed.<sup>13</sup> This process continues.<sup>14</sup>

### ***1 Common Law Following***

Common law following requires that the precise asset (or fund) or substituted asset (or fund) be ascertained.<sup>15</sup> However, the fund cannot be followed if the fund has been mixed so that it is not precisely identifiable.<sup>16</sup> It also appears that there is a

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<sup>10</sup> *Hunter v Moss* [1994] 1 WLR 452; cf *Herdegan v Federal Commissioner of Taxation* (1988) 84 ALR 271, 279 (Gummow J); David Hayton, 'Uncertainty of Subject-Matter of Trust' (1994) 110 *The Law Quarterly Review* 335.

<sup>11</sup> *Stephens Travel Service International Pty Ltd (Receivers and Managers Appointed) v Qantas Airways Ltd* (1988) 13 NSWLR 333; *Air Canada v M & L Travel Ltd* [1993] 3 SCR 787; *Air Traffic Conference v Downtown Center Inc* (1976) 14 AVI (CCH) 17, 172; *Forastieri v Eastern Airlines Inc* (1983) 81 AVI (CCH) 17, 145.

<sup>12</sup> Chapter 3, 102-106

<sup>13</sup> Chapter 2, 65-68.

<sup>14</sup> Gareth Jones, 'Tracing Claims in the Modern World' [1988-89] *King's Counsel* 15; John Glover, 'Bankruptcy and Constructive Trusts' (1991) 19 *Australian Business Law Review* 98; John Glover, 'Equity, Restitution and the Proprietary Recovery of Value' (1991) 14 *The University of New South Wales Law Journal* 247, 265-280; Penelope S Zohrab, 'Trust Claimants: The End of the Rainbow for Tracing Orders' (1993) *New Zealand Law Journal* 294; April G Mountfort, 'Tracing: An Examination of the Applicability of Tracing Principles Today' (1996) 70 *The Australian Law Journal* 54; Christa Band, 'The Development of Tracing Rules in Commercial Cases' [1997] *Lloyd's Maritime and Commercial Law Quarterly* 65; Cope, above n 2, 19-23; Peter Oliver, 'The extent of equitable tracing' (1995) 9 *Trust Law International* 78.

<sup>15</sup> Chapter 2, 65.

<sup>16</sup> *Taylor v Plumer* (1815) 3 M & S 562; 105 ER 721; *Re Diplock* [1948] Ch 465, 518-519; *Puma Australia Pty Ltd v Sportsman's Australia Ltd* [1994] 2 Qd R 159, 162 (McPherson ACJ) *Agip (Africa) Ltd v Jackson* [1990] 1 Ch 265; *Trustee of the Property of FC Jones & Sons (A Firm) v Jones*

requirement of the materiality of the property for common law tracing rules to operate.<sup>17</sup> Following, as it is applied today, is the subject of criticism.<sup>18</sup>

## **2 *Lipkin Gorman (A Firm) v Karpnale Ltd***<sup>19</sup>

Clear substitution can be used to follow money in and out of a bank account where it is impossible to expect the segregation of the money into a fund or an ascertainable asset. The record of a bank account which evidences the chose in action in favour of the depositor is regarded as a complete substitution for the money deposited.<sup>20</sup>

This process was creatively used in *Lipkin Gorman (A Firm) v Karpnale Ltd*. A partner in a firm of solicitors had drawn out funds from the firm's trust account. The partner was an authorised signatory, but he had withdrawn the funds for his personal addiction to gambling. He spent the money at a club. It appears that the partner did not have the resources to warrant an action against him for the money.<sup>21</sup> Therefore, the firm of solicitors brought an action against the club.

The House of Lords found that the gaming contract was void and therefore, the club had not provided valuable consideration for the money gambled.<sup>22</sup> The problem was that the Privy Council had earlier held that a partner who withdraws money from the firm's account obtains sole title to the money to the exclusion of the

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[1997] Ch 159; NH Andrews and J Beatson, 'Common Law Tracing: Springboard or Swan-song?' [1997] 113 *The Law Quarterly Review* 21.

<sup>17</sup> *Re Diplock* [1948] 465, 518-519; *Agip (Africa) Ltd v Jackson* [1990] 1 Ch 265, 285-286 (Millet LJ).

<sup>18</sup> See for example Smith, above n 2, 70-77; Salman Khurshid and Paul Matthews, 'Tracing Confusion' (1979) 95 *The Law Quarterly Review* 78.

<sup>19</sup> [1991] 2 AC 548. For helpful discussions of this case see Peter Birks, 'The English Recognition of Unjust Enrichment' [1991] *Lloyd's Maritime and Commercial Law Quarterly* 473; Brian F Fitzgerald, 'Tracing at Law, the Exchange Product Theory and Ignorance as an Unjust Factor in the Law of Unjust Enrichment' [1994] 13 *University of Tasmania Review* 116.

<sup>20</sup> *Re Diplock* [1948] Ch 466, 519; *Agip (Africa) Ltd v Jackson* [1990] 1 Ch 265, 285 (Millet J); *Trustee of the Property of FC Jones & Sons (A Firm) v Jones* [1997] Ch 159.

<sup>21</sup> [1991] 2 AC 548, 569 (Lord Goff).

<sup>22</sup> *Union Bank of Australia Ltd v McClintock & Co* [1922] 1 AC 240; *Commercial Banking Co of Sydney Ltd v Mann* [1961] AC 1.

firm. The House of Lords decided not to overrule these cases.<sup>23</sup> It held that that the common law debtor tracing trail had not come to an end. The solicitors were clients of the bank. The subject matter of the relationship was a chose in action which belonged to the solicitors at law. Therefore, the solicitors were able to trace the chose in action or its product.<sup>24</sup>

The decision is a product of legal compromise, which did not apparently resolve the friction between the negotiability of money and the fraud of the solicitor. The House of Lords effectively upheld the negotiability of money. Prima facie, the solicitor had acquired legal title to the money on the basis of his apparent authority. However, the fraudulent circumstances permitted the firm to re-assert its interest in the money at a later date - even though by that stage the money had become mixed into the assets of the club.<sup>25</sup> Lord Goff attempted to rationalise the development of a retrospective common law following theory on the basis that it was available against wrongdoers but not innocent recipients.<sup>26</sup> However, the fact was that the club was unaware that the money used to subsidise the gambling habit had been fraudulently obtained by the solicitor. It was not guilty of 'wrongdoing', except that the contract was technically illegal.

The judgment of Lord Goff has been subject to criticism because of the novelty of the common law tracing rules it applied.<sup>27</sup> It also remains unclear why the firm could not have brought an action based on breach of fiduciary obligations (owed by the partner of the firm), equitably tracing the money into the hands of the club and claiming the money (or more precisely its value or equivalent) on the basis of the failure of consideration.<sup>28</sup> However, the nature of the judgment highlighted the breakdown of the mechanical following process by stretching the concept of substitution.

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<sup>23</sup> *Lipkin Gorman (A Firm) v Karpnale* [1991] 2 AC 548, 573 (Lord Goff).

<sup>24</sup> *Ibid* 573-574.

<sup>25</sup> *Ibid*.

<sup>26</sup> *Ibid*.

<sup>27</sup> See for example, Burrows, above n 2, 67-68; Birks, above n 19, 473-497.

<sup>28</sup> See the comments of Gummow J in *Re Australian Elizabethan Theatre Trust* (1991) 102 ALR 681, 699.

## 2 Equitable Tracing

It is not surprising that equity's major case in relation to mixing of assets was *Re Hallett's Estate; Knatchbull v Hallett*<sup>29</sup> where a claim was made against bankers of a deceased fiduciary. In this case, equity permitted tracing of moneys into a mixed fund, a bank account. It is possible to trace into mixed funds which have arisen by virtue of the admixture of the funds belonging to two separate trusts<sup>30</sup> and the admixture of the funds personally belonging to the fiduciary and the trust.<sup>31</sup>

Sometimes, courts have rewritten the application of equitable tracing rules to achieve what they considered an appropriate result. The conventional view is that an errant trustee who withdraws money from the mixed fund, withdraws his own money first.<sup>32</sup> This approach works well unless the value of the amount in the mixed pool falls below the plaintiff's claim or the fund is dissipated altogether. In *Re Oatway; Hertslet v Oatway* ('Oatway')<sup>33</sup> a trustee paid deposited trust funds in his personal account and withdrew funds to purchase shares. He dissipated the remaining amount in the account. In order to provide the aggrieved plaintiff with proprietary relief, the court treated the shares as property obtained with the trust funds (and thus trust property).

A strict application of equity's tracing rules can have the unmerited effect of requiring a plaintiff to prove the existence of the equitable property, albeit in a substituted and/or mixed form. This means that the effective application of equity's tracing rules is determined by how the errant trustee dealt with the property rather than the relationship of the parties. Therefore, it is not surprising that Birks has

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<sup>29</sup> (1880) 13 Ch D 696; See Chapter 2, 68-69.

<sup>30</sup> *Devaynes v Noble; Clayton's case* (1816) 1 Mer 572; 35 ER 781; HAJ Ford and WA Lee, *Principles of the Law of Trusts* (3<sup>rd</sup> ed, 1996) [17250]; [17270]; RP Meagher and WMC Gummow, *Jacob's Law of Trusts in Australia* (6<sup>th</sup> ed, 1997) [2711]-[2712].

<sup>31</sup> *Brady v Stapleton* (1952) 88 CLR 322; *Scott v Scott* (1963) 109 CLR 649; Ford and Lee, above n 30, [17240]; [17245]; Meagher and Gummow, above n 30, [2709]-[2710].

<sup>32</sup> *Devaynes v Noble; Clayton's case* (1816) 1 Mer 572; 35 ER 781.

<sup>33</sup> [1903] 2 Ch 356.

posited the concept of negative asset which is in the form of specific surviving enrichment.<sup>34</sup> He states:

And there is at least one example of a negative asset: a debt discharged. That is, if you pay me money and I use it to discharge my overdraft or my mortgage, my enrichment survives in my release from these burdens. As the asset may be of various different kinds so also it may represent the original enrichment in varying extents, depending on what mixtures and substitutions have happened.<sup>35</sup>

However, recent case law indicates that some courts exercising equitable jurisdiction are more concerned with the relationship of the parties and the activity of the defendant, rather than the need for a proprietary base (albeit a negative one in the form of a surviving enrichment). And, this is understandable in the light of the fact that equity has always looked to the substance of matters rather than the form. Indeed, the argument for relief based on negative assets indicates that, notwithstanding proprietary base theory, following and tracing rules are beginning to break down.<sup>36</sup>

#### ***(a) Attorney-General for Hong Kong v Reid***<sup>37</sup>

A prime example can be found in relation to equity's changed attitude toward fiduciaries and bribes. In *Lister & Co v Stubbs*<sup>38</sup> the Court of Appeal held that the employer had no proprietary interest in bribes received by an employee because the funds in question had never belonged to the employer.<sup>39</sup> Thus, the fact that the fiduciary may acquire property directly from the breach of the fiduciary duties, did not give rise to a proprietary remedy. This attitude was consistent with the equitable

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<sup>34</sup> Birks, above n 1, (1985), 84, 372-375, 397-399; cf *Thompson v Clydesdale Bank Ltd* [1893] AC 283, 291-292 (Lord Shand); Smith, above n 2, 150-152; Lionel D Smith, 'Tracing into the Payment of a Debt' (1995) 54 *The Cambridge Law Journal* 290, 296-300; Cope, above n 2, 153.

<sup>35</sup> Birks, above n 1, 84.

<sup>36</sup> For a helpful discussion of the various permutations of the tracing rules in reaction to the inherent problems see Cope, above n 2, Chapter 10.

<sup>37</sup> [1994] 1 AC 324.

<sup>38</sup> (1890) 45 Ch D 1.

<sup>39</sup> *Ibid* 15 (Lord Lindley).



tracing rules which require that the property in dispute must be traceable and have a direct nexus to the proprietary interest of the beneficiaries.

In *Attorney-General for Hong Kong v Reid* the Privy Council ruled on an appeal from the Court of Appeal in New Zealand in relation to another bribery case. The respondent, whilst a Crown servant in Hong Kong, had accepted bribes in breach of a fiduciary relationship with which he had purchased properties in New Zealand. The issue was whether the appellant was entitled to the property. The Privy Council decided in favour of the appellant and overruled *Lister v Stubbs*. Lord Templeman (who delivered the advice of the Privy Council) said:

it is said that if the false fiduciary holds property representing the bribe in trust for the person injured, and if the false fiduciary is or becomes insolvent, the unsecured creditors of the false fiduciary will be deprived of their right to share in the proceeds of that property. But the unsecured creditors cannot be in a better position than their debtor. The authorities show that property acquired by a trustee innocently but in breach of trust and the property from time to time representing the same belong in equity to the cestui que trust and not to the trustee personally whether he is solvent or insolvent. Property acquired by a trustee as a result of the criminal breach of trust and the property from time to time representing the same must also belong in equity to his cestui que trust and not to the trustee whether he is solvent or insolvent.<sup>40</sup>

If a trustee mistakenly invests money which he ought to pay over to his cestui que trust and then becomes bankrupt, the moneys together with any profit which has accrued from the investment are withdrawn from the unsecured creditors as soon as the mistake is discovered. A fortiori if a trustee commits a crime by accepting a bribe which he ought to pay over to his cestui que trust, the bribe and any profit made therefrom should be withdrawn from the unsecured creditors as soon as the crime is discovered.<sup>41</sup>

Thus, the Privy Council held that the properties were held on constructive trust, even though such assets had never belonged to the beneficiary. However, the case did pose some pertinent questions. It is unclear what would have been the result if there had been evidence that the bribe moneys had not been used to purchase the

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<sup>40</sup> Ibid 331.

<sup>41</sup> Ibid 336.

properties in New Zealand and/or there was an insufficient nexus between the bribes and the assets of the respondent. The Privy Council was not called upon to decide whether the appellant would have had a vested interest in the assets of the respondent, if the evidence had shown that the bribes had been dissipated, rather than astutely invested.

Some commentators have generally welcomed the development in *Reid*.<sup>42</sup> Beatson<sup>43</sup> has quite properly characterised the case as 'a version of the 'swollen assets' theory.'<sup>44</sup> Cope has expressed a similar view.<sup>45</sup> However, Birks has questioned the breakdown of the distinction between property and obligation. The result would be the loss of certainty and property interests based on judicial discretion.<sup>46</sup> The question which Birks cannot answer satisfactorily is why should a wrongdoing fiduciary benefit from his wrongdoing and swell his assets? Academic distinctions based on a proprietary based theory do not ensure that fiduciaries take their obligations seriously.

***(b) Lord Napier and Ettrick v Hunter***<sup>47</sup>

There has also been tentative developments in *Lord Napier and Ettrick v Hunter* ('*Napier*') towards awarding proprietary remedies to commercial parties to whom no fiduciary obligations are owed. The insured had been paid out under the insurance policy and had also received compensation from the wrongdoing third party. The House of Lords held that the stop loss insurers were entitled, under the doctrine of subrogation, to a lien over settlement moneys received from the

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<sup>42</sup> Donovan Waters, 'Proprietary Relief: Two Privy Council Decisions - A Canadian Perspective' [1995] 25 *Canadian Business Law Journal* 90, 92; Thomas Allen, 'Bribes and Constructive Trusts: *A-G of Hong Kong v Reid*' (1995) 58 *The Modern Law Review* 87.

<sup>43</sup> J Beatson, 'Proprietary Claims in the Law of Restitution' (1995) 25 *The Canadian Business Law Journal* 66.

<sup>44</sup> *Ibid* 84.

<sup>45</sup> Cope, above n 2, 97.

<sup>46</sup> P Birks, 'Property in the Profits of Wrongdoing' (1994) 24 *The University of Western Australia Law Review* 8, 15-16.

<sup>47</sup> [1993] AC 713.

wrongdoer.<sup>48</sup> Victims of wrongdoing are not entitled to double compensation.<sup>49</sup> The result of the case is that the law of subrogation was given some proprietary teeth.<sup>50</sup>

The decision has been criticised for granting the insurers a proprietary base where the fund never belonged to the insurers.<sup>51</sup> However, such criticism fails to recognise that a number of processes were at work. The House of Lords was ensuring that the underlying philosophy of the law of subrogation, the prevention of unconscionable conduct<sup>52</sup> was fulfilled, notwithstanding the insolvency. Moreover, the House of Lords was ensuring that a party should not swell his assets to the detriment of another, although this was not how it was described. There was no evidence to suggest that the stop loss insurers had not taken on the risk of the insolvency of the insured. However, it was equally the case that the stop loss insurers had not taken on the risk that they would not be able to utilise subrogation so as to receive an equivalent of the amount paid out.<sup>53</sup> Having decided that the stop loss insurers could access proprietary rights on the basis of the law of subrogation, the insurers were required to trace the funds into the hands of the insured. The lien was over the settlement moneys.<sup>54</sup> The innovation in *Napier* showed that insurers were able to access equity's limited tracing rules in the context of a commercial contract - a contract of insurance where they had not held the proprietary interest in the fund which was subject to dispute.

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<sup>48</sup> Ibid 737-739 (Lord Templeman); 742-745 (Lord Goff), 750-752 (Lord Browne-Wilkinson).

<sup>49</sup> RP Meagher, WMC Gummow and JRF Leane, *Equity: Doctrines and Remedies* (3<sup>rd</sup> ed., 1992), [511]; Lord Goff of Chieveley and Gareth Jones, *The Law of Restitution* (4<sup>th</sup> ed, 1993), 589-591; Chapter 31; John Glover, 'Subrogation' in Patrick Parkinson (ed), *The Principles of Equity* 549, (1996) [1501].

<sup>50</sup> See also *Banque Financière de la Cité v Parc (Battersea) Ltd* [1998] 2 WLR 475.

<sup>51</sup> Charles Mitchell, *The Law of Subrogation* (1994) 82-84; Charles Mitchell, 'Subrogation and insurance law: proprietary claims and excess clauses' [1993] *Lloyds Maritime and Commercial Law Quarterly* 192.

<sup>52</sup> See for example, *Lord Napier and Ettrick v Hunter* [1993] AC 713, 738 (Lord Templeman); *Orakpo v Manson Investments Ltd* [1978] AC 95. In relation to unjust enrichment see *Banque Financière de la Cité v Parc (Battersea) Ltd* [1998] 2 WLR 475.

<sup>53</sup> Note also Chapter 2, 87-88.

<sup>54</sup> See for example *Lord Napier and Ettrick v Hunter* [1993] AC 713, 738 (Lord Templeman); 752 (Lord Browne-Wilkinson).

***(c) Space Investments Ltd v Canadian Imperial Bank of Commerce Trust Co (Bahamas) Ltd*<sup>55</sup>**

In *Space Investments Ltd v Canadian Imperial Bank of Commerce Trust Co (Bahamas) Ltd* ('Space'), it was held that a bank which was the trustee of various settlements (which was permitted to invest in any bank including itself), had properly invested the money with itself. However, Lord Templeman also considered the situation where, contrary to the terms of the settlement, the trustee bank deposited the funds with itself and mixed the funds with its own assets to the extent that there was no identifiable mixed pool - except perhaps the entire assets of the bank as a pool of assets. Conformity to equity's tracing rules would be impossible. In a helpful statement Lord Templeman said:

A bank in fact uses all deposit moneys for the general purposes of the bank. Whether a bank trustee lawfully receives deposits or wrongly treats trust money as on deposit from trusts, all the moneys are in fact dealt with and expended by the bank for the general purposes of the bank. In these circumstances it is impossible for the beneficiaries interested in trust money misappropriated from their trust to trace their money to any particular asset belonging to the trustee bank. But equity allows the beneficiaries, or a new trustee appointed in place of an insolvent bank trustee to protect the interests of the beneficiaries, to trace the trust money to all the assets of the bank and to recover the trust money by the exercise of an equitable charge over all the assets of the bank. Where an insolvent bank goes into liquidation that equitable charge secures for the beneficiaries and the trust priority over the claims of the customers in respect of their deposits and over the claims of all other unsecured creditors....

It is therefore equitable that where the trustee bank has unlawfully misappropriated trust money by treating the trust money as though it belonged to the bank beneficially, merely acknowledging and recording the amount in a trust deposit account with the bank, then the claims of the beneficiaries should be paid in full out of the assets of the trustee bank in priority to the claims of the customers and other unsecured creditors of the bank. 'If a man mixes trust funds with his own, the whole will be treated as the trust property... that is, that the trusts property comes first...' per Sir George Jessel MR in *In re Hallett's Estate* (1880) 13 Ch D 696, 719, adopting and explaining earlier pronouncements to the same effect. Where a bank trustee is insolvent, trust money wrongfully treated as being on deposit with the

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<sup>55</sup> [1986] 1 WLR 1072.

bank must be repaid in full so far as may be out of assets of the bank in priority to any payment of customers' deposits and other unsecured debts.<sup>56</sup>

In the event that tracing rules were inapplicable, beneficiaries would be entitled to far more than simply a judgment debt. They would be entitled to priority over all the bank's other unsecured creditors.

The suggested operation of equity in *Space* fulfils the centrality of trust and confidence in fiduciary relationships. Priority was not simply linked to a specific property or a mixed fund. Whilst the Court envisaged that a bona fide bank trustee will segregate trust assets from its own, segregation was (and is) not a precursor to an action to recover the money because beneficiaries do not assume the risk of a trustee's insolvency.<sup>57</sup> Thus, the priority extended over the defendant's assets including non-monetary assets. This is a most provocative point. The Court disguised the inherent radicalism of its approach by attempting to bring the judgment within the principles of *Re Hallett's Estate*.<sup>58</sup> However, in that case, it would not have been open to the client to trace the moneys into the assets of the solicitor generally because equitable tracing is asset specific. When the Court of Appeal in *Re Hallett's Estate* referred to the mixing of money, it had an eye to the mixing of funds in a specific bank account. In *Space*, Lord Templeman interpreted the words 'mixes trust funds with his own' as not pertaining simply to the specific larger fund into which a plaintiff's moneys may be mixed, but the admixture of the moneys to the assets of the defendant as a whole. Such a construction has the potential to radically change equitable tracing because it is sufficient if the plaintiff can establish that the defendant received the money.

This trend has been evident in the United States. It has also been pointed out that the *Restatement of the Law Second, Restitution*<sup>59</sup> may permit proprietary relief which is not connected to specific and ascertainable assets.<sup>60</sup> This may occur where

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<sup>56</sup> Ibid 1074.

<sup>57</sup> Ibid.

<sup>58</sup> (1880) 13 Ch D 696.

<sup>59</sup> American Law Institute, *Restatement of the Law Second, Restitution, Tentative Draft No 2* (1984) § 33.

<sup>60</sup> Jones, above n 14, 17-18.

the wrongdoing has been conducted in such a way that the victim is prevented from identifying specific proceeds. Although this is quite limited, it does show a loosening of the proprietary base requirement.

*Space* has been subject to considerable criticism on the basis that it does not accord with equitable tracing and does not protect the interests of unsecured creditors.<sup>61</sup> Indeed, *Re Goldcorp Exchange Ltd (In Receivership) ('Goldcorp')*,<sup>62</sup> *Boscawen v Bajwa*<sup>63</sup> and *Bishopsgate Investment Management Ltd (in liq) v Homan ('Bishopsgate')*<sup>64</sup> indicate the approach in *Space* is not favoured at the present time. In *Goldcorp*,<sup>65</sup> Lord Mustill said that the obiter dicta in *Space* concerned a mixed rather than a non-existent fund. Therefore, the obiter was not applicable to the facts of the case.<sup>66</sup> In *Bishopsgate*,<sup>67</sup> it was confirmed that equitable tracing cannot be pursued through an overdrawn account and the obiter in *Space* was limited as envisaged by Lord Mustill in *Goldcorp*.<sup>68</sup>

In *Westdeutsche Landesbank Girozentrale v Islington London Borough Council ('Westdeutsche')*<sup>69</sup> Lord Browne-Wilkinson took a strict proprietary base approach. Envisaging that the appropriate proprietary remedy is likely to be the remedial constructive trust, he specified that the trust res should be identifiable.<sup>70</sup> In this respect, the case is similar to the reasoning in *Napier* and the outcome in *Attorney-General v Reid*. However, it fails to take into account the fluidity of the

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<sup>61</sup> RM Goode, 'Ownership and Obligation in Commercial Transactions', (1987) 103 *The Law Quarterly Review*, 433, 446-447; Smith, above n 2, 231, 312-315.

<sup>62</sup> [1995] 1 AC 74.

<sup>63</sup> [1996] 1 WLR 328.

<sup>64</sup> [1995] Ch 211.

<sup>65</sup> [1995] 1 AC 74.

<sup>66</sup> *Ibid* 103-105.

<sup>67</sup> [1995] Ch 211.

<sup>68</sup> *Ibid* 218-220 (Dillon LJ); 221-222 (Leggatt LJ).

<sup>69</sup> [1996] AC 669.

<sup>70</sup> *Ibid* 705.

concept of certainty of subject matter in trust law, particularly where fungibles are concerned.<sup>71</sup>

The reticence to adopt the line of thinking enunciated by Lord Templeman in *Space* is due to three reasons. First, there has not been sufficient appreciation that in the light of the changing nature of money, it is no longer feasible to strictly apply common law following and equitable tracing. Secondly, it is assumed that the alternative to the application of the equitable tracing is an anarchic system in which all claims to proprietary relief are met without any recourse to principle. As will be shown, this is far from the truth. Thirdly, it is assumed that common law following and equitable tracing are valueless mechanical rules. Yet, a radical aspect of *Space* was that Lord Templeman freed equitable tracing from illogical practical restraints. However, he did not divest the obiter dicta from the equitable values which led to their inception.

This would seem to indicate that an important step towards a principled and inherently coherent system of proprietary relief was made via the obiter dicta in *Space* and swollen assets theory.

#### IV SWOLLEN ASSETS THEORY

During the Great Depression which commenced in 1929, some courts in the United States moved seriously towards liberalising equity's tracing requirements and opening up the situations where parties could access proprietary remedies. The period was characterised by unprecedented and sudden economic dislocation, insolvency and unemployment.<sup>72</sup> The trend away from the rigid application of equity's tracing rules started to become apparent well before the Depression. However, it was the advent of the Depression which gave rise to the urgent need for the re-evaluation.

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<sup>71</sup> *Hunter v Moss* [1994] 1 WLR 452.

<sup>72</sup> See generally J K Galbraith, *A Journey Through Economic Time: A First Hand View* (1994) Chapters 7 and 8.

## *A Versions of the Swollen Assets Theory*

Three separate kinds of swollen assets theory have been identified.<sup>73</sup> The first kind is the 'weak version' in which the claimant is required to show the defendant's receipt of the fund in dispute. Having established the fact of receipt, the burden of proof is shifted on the defendant to show that he does not retain the original asset or the traceable proceeds.<sup>74</sup> Therefore, if the defendant no longer retains the asset in its original, substituted or mixed form, the defendant is not required to disgorge the asset in whatever form, notwithstanding the fact that the defendant has acted unconscionably. The so-called 'weakened version' of the swollen assets theory does not address the central issue of the relationship and obligations of the parties. It is still primarily concerned with the mechanics of ascertaining assets or funds. Therefore, it is simply a variation of equitable tracing.

The second version of the swollen assets theory is the 'augmentation version' where the plaintiff is required to prove that the defendant received the asset in dispute and that the asset augmented and continues to augment the defendant's asset base at the time of the insolvency.<sup>75</sup> Augmentation is discussed below.<sup>76</sup> Suffice to say, that the augmentation version is also linked to the limitations of the tracing rules generally. Whilst the plaintiff is supposedly not required to undertake technical tracing exercise, he is unable to prove augmentation without such an exercise. Otherwise, the defendant is not required to disgorge the asset despite the defendant's unconscionable conduct. Moreover, once the asset is dissipated, there is no longer any augmentation of the defendant's estate and proprietary relief is not possible.

The third and only true version of the swollen assets theory simply requires the plaintiff to prove that the defendant received the assets or funds in dispute.<sup>77</sup> The nature of the relationship of the parties and the conduct of the defendant will

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<sup>73</sup> Smith, above n 2, 270-274, 310-320. Note also the discussion in Kingsley A Taft, 'A Defense of a Limited Use of the Swollen Assets Theory Where Money Has Wrongfully Been Mingled With Other Money' (1939) 39 *Columbia Law Review* 172.

<sup>74</sup> Smith, above n 2, 270; For a possible manifestation of this kind of swollen assets theory in English law see Oliver, above n 14, 78, 81-83.

<sup>75</sup> Smith, above n 2, 271.

<sup>76</sup> Below, 154-159.

<sup>77</sup> Note the description of Smith, above n 2, 271, 311-315.



determine whether the plaintiff is entitled to proprietary relief. The remaining discussion is principally related to this form of the swollen assets theory.

There have been its proponents such as Taft,<sup>78</sup> Hirsch<sup>79</sup> and sympathisers such as Oesterle<sup>80</sup> who have argued that a defendant should not be entitled to retain assets unjustly even if the original assets can no longer be identified. The application of the identifiability requirement has the effect of augmenting the defendant's asset base; or, to put it another way, the full quantum of the assets available to the defendant for distribution amongst the creditors is enhanced.

### ***B Early Authorities***

A case which has been identified as leading to the development of swollen assets theory<sup>81</sup> was *Peak v Ellicott* which was decided in 1883.<sup>82</sup> The plaintiff borrowed money from the defendant bank and then executed a note acknowledging the indebtedness. The bank had sold the note for valuable consideration to a third party which held the note. The plaintiff paid the bank the amount which was due on the note and requested that the bank pay that amount to the third party. The bank became insolvent and the question was whether the plaintiff had a proprietary interest for an amount equivalent to the amount in dispute. The Court held that the bank received the money as agent of the plaintiff, that a fiduciary relationship arose between the parties and that the bank received and held the money as a trust fund and not as part of the assets of the bank. The case located two features which were to become synonymous with the swollen assets theory. One feature was that the circumstances of a common law relationship which would otherwise accord personal rights and liabilities, could give rise to a proprietary interest in the assets of an insolvent entity. The other feature indicated that the technicalities of the tracing rules

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<sup>78</sup> Taft, above n 73, 175-176.

<sup>79</sup> Sylvan H Hirsch, 'Tracing Trust Funds - Modern Doctrines' (1936-1937) 11 *Temple Law Quarterly* 11-12.

<sup>80</sup> Dale A Oesterle, 'Deficiencies of the Restitutionary Right to Trace Misappropriated Property in Equity and in UCC § 9-306' (1982-1983) 68 *Cornell Law Review* 172, 189 fn 33.

<sup>81</sup> George Gleason Bogert and George Taylor Bogert, *Handbook of the Law of Trusts* (4<sup>th</sup> ed, 1963), 585 fn 34.

<sup>82</sup> 1 P 499 (SC Kansas, 1883); See also Bogert and Bogert, above n 81, 585 fn 34.

were not belaboured. It was assumed that the assets could be traced because the bank had received them.

In *Evangelical Synod of North America v Schoeneich*<sup>83</sup> Burgess J considered the situation where a trustee deposited money with a firm without the required consent of the beneficiaries and the firm became insolvent. The Court had no hesitation holding that the trustee had acted in breach of his duties and that the beneficiaries were entitled to take action to recover the money. Certainly, keeping in mind the obiter dicta of Lord Templeman in *Space*,<sup>84</sup> it could be said that the beneficiary did not take on the risk of the trustee's wrongdoing. The problem was that in fact it was going to be very difficult to trace the moneys. If the money could not be identified in a segregated, mixed or substituted form, the beneficiary's action would fail. Burgess J acknowledged the substantial authority which required identifiability.<sup>85</sup> However, His Honour referred to some authorities which did not require identifiability<sup>86</sup> and said:

But the modern doctrine, and especially the adjudications by the appellate courts of this state, go further, and hold that when a trustee or bailee wrongfully mixes trust money with his own, so that it cannot be distinguished what particular part is trust money and what part is private money, equity will follow the money, by taking out of the insolvent estate the amount due the cestui que trust, although it cannot be identified, or separated from other funds with which it was mixed.<sup>87</sup>

This was a remarkable extension of the equity tracing rules. It permitted the courts to abandon the difficult and time consuming process of identifying money or its substitute.

The decision also represented a farsighted approach to the problem of remedy. Burgess J held that if the funds in question had been received but could no

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<sup>83</sup> 45 SW 647 (SC Missouri, 1898).

<sup>84</sup> [1986] 1 WLR 1072.

<sup>85</sup> 45 SW 647 (SC of Missouri, 1898), 648-649.

<sup>86</sup> Ibid 649-650; *Bryan v Coconut Grove Bank & Trust Co* 132 So 481 (SC Florida, 1931).

<sup>87</sup> Ibid 649.

longer be identified, then the remedy would have to take this into account. He stated, citing *Stollar v Coates*,<sup>88</sup> that

...the general assets of the insolvent bank having received the benefit of the unlawful conversion of a trust fund, the bank was chargeable with the amount of the converted fund, as a preferred demand; that, while it may be possible to follow a fund into its diverted use, it is always possible to make a charge upon the estate or assets to the increase or benefit of which it had been appropriated, and, the general assets of the bank having received the benefit of the unlawful conversion, there is nothing inequitable in charging them with the amount of the converted fund, as a preferred demand.<sup>89</sup>

The acceptance of swollen assets theory was neither widespread nor sustained. Historically, standard equity tracing principles were followed without question by many judges even in times of an extraordinary economic Downturn.<sup>90</sup> Indeed, the Bogerts have pointed out that many of the cases establishing the swollen assets theory were subsequently expressly overruled on this basis.<sup>91</sup> An examination of the case law which Hirsch<sup>92</sup> suggests stands for the modern swollen assets approach indicates that some of the cases may be interpreted as supporting in effect the orthodox rules and/or indeed positively identifying with them.<sup>93</sup> The tracing exercise is limited to the mixed fund of cash assets rather than the whole of the assets of the debtor/bank.

Moreover, in the hands of some judges, the pure swollen assets theory was turned on its head. Courts did not deny that it was important that a party to whom the fiduciary obligation was owed, should have the ability to recover the assets which had been wrongly diverted from the trust. But, some courts required that there should be a discernible augmentation of the assets of the defendant.<sup>94</sup> Thus, neither the

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<sup>88</sup> 88 Mo 514 (SC Missouri, 1885).

<sup>89</sup> *Evangelical Synod of North America v Schoeneich* 45 SW 647 (SC Missouri, 1898), 650.

<sup>90</sup> Hirsch, above n 79, 18.

<sup>91</sup> Bogert and Bogert, above n 81, 585 fn 34.

<sup>92</sup> Hirsch, above n 79, 20 fn 37.

<sup>93</sup> See for example *First National Bank of Danville v Commercial Bank & Trust Co* 175 SE 775 (SC Virginia, 1934); *American Express Co v Cochrane* 137 So 696 (SC Florida, 1931).

<sup>94</sup> *Kershaw v Jenkins* 71 F (2d) 647 (10<sup>th</sup> Cir, 1934), 649.

payment of debts<sup>95</sup> nor the shifting of credit in a bank, would serve as a basis for proof of augmentation.<sup>96</sup> Augmentation became synonymous with identifiability and substitutability.

### ***C Reaction to the Swollen Assets Theory***

Three main arguments have arisen in an attempt to discredit the theory and each of these will be considered in turn.

#### ***1 No Factual Augmentation of Assets***<sup>97</sup>

It is argued that the swollen assets theory does not represent a factual augmentation of assets. If there is no factual augmentation of assets, how can it be said that there has been a swelling of the assets in the hands of the defendant? George G Bogert and George T Bogert maintain that:

The fallacy of the 'swollen assets' theory lies in its failure to recognise that a trust requires specific property as its subject-matter, and that the very essence of the beneficiary's right to trace is his ability to identify the trust res or its exact substitute. As a creditor a beneficiary is entitled to no preference over any other creditor. It is only as a property owner that he is entitled to take particular personalty or realty. The matter is illuminated by the court in *Slater v Oriental Mills*:...

They quoted from *Slater v Oriental Mills*,<sup>98</sup> including the following:

'But right here comes the argument that it is equitably his own because the debtor has taken the claimant's money and mingled it with his estate, whereby it is swelled just so much. But, as applicable

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<sup>95</sup> Note the earlier case *City of Lincoln v Morrison* 90 NW 905 (SC Nebraska, 1902).

<sup>96</sup> *Edisto National Bank of Orangeburg SC v Bryant* 72 F (2d) 917 (4<sup>th</sup> Cir, 1934).

<sup>97</sup> *Burnes National Bank of St Joseph, Mo v Spurway* 28 F (2d) 40 (District Court Iowa, 1928); *National Bank of the Republic v Porter* 258 P 544 (SC Idaho, 1927); *Re Citizen's State Bank of Gooding* 255 P 300 (SC Idaho, 1927); *City of Lincoln v Morrison* 90 NW 905 (SC Nebraska, 1902); *Kershaw v Jenkins* 71 F (2d) 647 (10<sup>th</sup> Cir, 1934); *Edisto National Bank of Orangeburg SC et al v Bryant* 72 F (2d) 917 (4<sup>th</sup> Cir, 1934); *Harmer v Rendleman* 64 F (2d) 422 (4<sup>th</sup> Cir, 1933); cf *Orr v St Louis Union Trust Company* 236 SW 642 (SC Missouri, 1922); *Nelson v McClean's Estate* 161 SW (2d) 676 (Kansas City Court of Appeals, 1942).

<sup>98</sup> 27 A 433 (SC Rhode Island, 1893), 443.

in all cases, the argument is not sound. Where the property or its substantial equivalent remains, we concede its force; but, where it is dissipated and gone, the appropriation of some other property in its stead simply takes from creditors that which clearly belongs to them...Though the particular money cannot be identified the amount is swelled just as much, and the amount added belongs to the cestui que trust....<sup>99</sup>

Then they continued:

A further fallacy in the swollen assets doctrine is its assumption that the use of the trust funds to pay the trustee's personal debts has swollen the estate which he leaves. As a matter of fact such use has the effect of paying one debt at the same time creating another of exactly the same size, so that the estate is neither swollen or diminished. Thus if T is trustee of the A trust, has in his hands \$1,000 of trust money, and owes personally \$500 to X and \$1,000 to Y, and the only property T owns personally is a bond worth \$500, it is apparent that T is insolvent. He owes \$1500 and owns \$500. The trust property does not count in the private affairs of T, either as an asset or liability, as long as T is carrying out his trust. Now if T uses the \$1000 of trust money to pay his creditor, Y, and dies, it cannot be said that the use of the trust money has 'swollen' the estate left by T. The estate still has assets of \$500 and liabilities of \$1500. Instead of owing Y \$1000, his estate owes the trust \$1,000 on account of the misappropriated funds.<sup>100</sup>

These authors have described the infusion of trust funds into the assets of a trustee as neither increasing nor diminishing the asset base of the trustee because the trustee still owes what he has received. There has been no factual augmentation of the assets. However, the example they use to demolish the swollen assets theory is unconvincing, particularly in the insolvency context. If T is insolvent, the question is whether the payment to Y was a fraudulent disposition or a voidable preference<sup>101</sup> and/or whether Y took the money with notice that the funds were trust funds

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<sup>99</sup> Ibid.

<sup>100</sup> Bogert and Bogert, above n 81, 586-587. See the dissenting judgment of Taylor and Cassody JJ in *Frances v Evans* 33 NW 93 (1887); *Slater v Oriental Mills* 27 A 443 (SC Rhode Island, 1893) Austin Wakeman Scott and William Franklin Fratcher, *The Law of Trusts* (4<sup>th</sup> ed, 1987) vol V, §521.2.

<sup>101</sup> *Bankruptcy Act 1966* (Cth) ss 121 and 122. In relation to the law governing fraudulent dispositions and voidable preferences see Dennis Rose, *Lewis: Australian Bankruptcy Law*, (10<sup>th</sup> ed, 1994), Chapters 20 and 21; PP McQuade and MGR Gronow, McDonald, Henry and Meek, *Australian Bankruptcy Law and Practice* (5<sup>th</sup> ed, 1996) [121.0]-[122.8.05].

(including whether the funds were still identifiable in Y's hands). If the answer to this question is no and Y is a *bona fide* purchaser for value without notice, then the trust would compete with the other unsecured creditors for the funds which remained in the hands of T or his administrator. To say that the assets of T had not been swollen is simply not true. If, as suggested, the trust funds were not part of either the assets or liabilities of T, then T had liabilities of \$1500. His estate would now have personal liabilities of \$500.

Another and possibly better example of the swollen assets theory at work, is where there are multiple unsecured creditors. A is an insolvent which operated as a stockbroker. Each day thousands of electronic transactions passes between A and his creditors. A owes \$1,000,000 to 100 creditors. A has received \$100,000 from Z pursuant to a mistaken overpayment. The money is not ascertainable because the funds have immediately disappeared into the 'black hole' of the overdrawn account.<sup>102</sup> A has assets of \$200,000. The question is whether Z can obtain a proprietary remedy equivalent to \$100,000.

If Z is treated as an unsecured creditor then (assuming there are no secured creditors and leaving aside statutory preferential creditors) Z would be treated equally and rateably with the other unsecured creditors. Z would be entitled to \$20,000. Another creditor, P who is owed \$200,000, would be entitled to \$40,000 and so on. But, if it can be said that Z is an unsecured creditor who cannot be treated the same way as other unsecured creditors because Z did not take on the risk of the debtor's insolvency, then A is not entitled to retain the assets or use them to partially pay off outstanding debts. To treat Z as simply an unsecured creditor would be to swell the assets of the debtor. Thus, if Z has not taken on the risk of the insolvency, A has at its disposal an additional \$100,000 which it would not have had otherwise. A is able to pay a greater amount of the outstanding debt than he would otherwise have been able. The other creditors obtain a larger amount than they would have otherwise received. If A has assets of only \$100,000, then P would only receive \$20,000 - one half of the amount under the previous scheme. What the swollen assets theory identifies is that where a debtor's accounts are swelled by funds to which the debtor is not entitled due to the breach of fiduciary duty and/or the unusual nature of the transfer or the receipt of the funds, the debtor and his other creditors receive an

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<sup>102</sup> *Re Diplock* [1948] 1 Ch 465, 521; *Bishopsgate Investment Management Ltd (in Liquidation) v Homan* [1995] Ch 211.

unwarranted benefit. In this case, P receives \$40,000 rather than \$20,000 whilst Z receives only \$20,000 instead of \$100,000.<sup>103</sup>

Another example, is where A spends the money received from Z on a holiday, and dissipates the whole amount. The asset base of A remains swollen to the detriment of Z because if A wanted to enjoy the holiday, A would have otherwise had to spend his own money. One possible suggestion is to describe it as the creation of a negative asset which is in the form of a specific surviving enrichment.<sup>104</sup> The problem is whether the expenditure saved can be interpreted as a specific saving enrichment. A's asset base has been 'swelled' at the expense of Z because A has been able to utilise the fund and dissipate it.

Scott was another staunch advocate of the present approach to equitable tracing.<sup>105</sup> In the seminal work on the law of trusts subsequently co-authored with Fratcher,<sup>106</sup> Scott set out to demolish the swollen assets theory<sup>107</sup> and re-affirm that the actual tracing of property in accordance with the orthodox approach remains preferable.

In relation to the augmentation debate, they (like the Bogerts) dismissed the argument that there should be recovery where that wrongdoer's estate has been originally augmented and the 'wrongdoer' has dissipated the asset. They stated:

the wrongdoer's estate is no larger than it would have been if he had not taken the claimant's property. The general creditors, therefore, are not seeking to obtain a larger amount from the wrongdoer's estate than they would have received if no wrong had been committed. They are not seeking to profit through the wrong. On the contrary the claimant is seeking to diminish the amounts that the creditors are to receive. He is certainly not entitled to priority over the other creditors.<sup>108</sup>

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<sup>103</sup> Oesterle, above n 80, 189-190 fn 33.

<sup>104</sup> Birks, above n 1, 84.

<sup>105</sup> Austin W Scott, 'The Right to Follow Money Wrongfully with Other Money' (1913-1914) 27 *Harvard Law Review* 125.

<sup>106</sup> Scott and Fratcher, above n 100.

<sup>107</sup> *Ibid* vol V, § 521.

<sup>108</sup> *Ibid* vol V, §521, 653.

Under the swollen assets theory, so long as it could be shown that the assets of the recipient have been ultimately augmented due to the wrongdoing, it does not matter that the assets have been subsequently dissipated. While they admitted that this appeared to be fair, they pointed to 'difficulties that are almost insuperable',<sup>109</sup> which would face courts. Where the money has been dissipated, courts have to decide whether or not the 'wrongdoer' would have spent his own money for the same purpose. Where courts have decided that this was the case - then it has been suggested that the 'victim' would have priority. However, they argued that under the pure swollen assets theory, the victim would not fare so well if the wrongdoer retained the victim's assets but the estate appeared no larger than if the wrong had not been committed.<sup>110</sup> Such a situation would arise when the defendant paid his debts with the money he received and therefore his current assets were not augmented. On the basis of this assessment, they decided that orthodox tracing was better than swollen assets theory because the victim could trace into a mixed fund regardless of whether the wrongdoer's assets were ultimately augmented at the time of the insolvency.

They stressed that courts will have to decide whether the 'wrongdoer' actually benefited from the dissipation to his own advantage. This 'insuperable difficulty' was not insuperable at all if a basic presumption in equitable tracing itself was applied. In *Oatway*<sup>111</sup> the court assumed, in relation to the application of equitable tracing, that the trustee/fiduciary will dissipate his own money before spending money belonging to another to whom a fiduciary obligation was owed.<sup>112</sup> *Oatway* in fact turned the argument on its head, because it suggested that courts will assume that a party will spend his own money first so that the moneys in dispute would remain. However, *Oatway* does not and cannot determine whether a party would have actually spent money if he was aware that it was not his own.

At any rate, care should be taken to separate two very different issues - a basis for a cause of action and a defence. The first issue is whether the fiduciary has benefited from the receipt of the moneys. The answer must be that the fiduciary has benefited from receipt of the assets. There has been an initial augmentation of the

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<sup>109</sup> Ibid.

<sup>110</sup> Ibid vol VA, §521, 654.

<sup>111</sup> [1903] 2 Ch 356.

<sup>112</sup> Ibid.



assets. In cases which apply to the third version of the swollen assets theory, the personal reason why the trustee/fiduciary dissipated trust assets (or mixed them so that the assets became completely untraceable), was irrelevant. What was important was that the defendant had received funds to which the court did not consider the defendant was *prima facie* entitled. At that point, the courts were concerned with the circumstances of the receipt, rather than whether there was a permanent augmentation of the defendant's assets. On the other hand, the issue of whether or not the defendant then spent the money as his own and/or whether the defendant would have spent the money in the first place is a matter for subsequent consideration. Rather than discussing this issue as part of the concept of swollen assets theory, it is better to view the matter from the angle of a defence. Does the defendant have a defence that he dissipated the assets in the genuine belief that they belonged to him? The defence of change of position may be the answer to Scott's and Fratcher's dilemma.<sup>113</sup>

Swollen assets theory begins where the equitable tracing rules finish. Viewed from the perspective of a proprietary approach of equitable tracing, there is no augmentation of A's assets because the property which originally augmented those assets no longer exists. Non-existent property cannot augment an existing asset base. Whilst it is possible to trace money into a mixed fund,<sup>114</sup> it is not possible to argue that after dissipation of one fund another replaces it.<sup>115</sup> This is the case even where what is at stake are the interests of beneficiaries who have not taken on the risk of the trustee's insolvency. The existence of swollen assets theory represents an acknowledgment by some courts that equitable tracing, though helpful, may not go far enough, where the entitlement of a party to recover funds solely depends on the traceability of money and the augmentation of assets.

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<sup>113</sup> *Lipkin Gorman (A Firm) v Karpnale Ltd* [1991] 2 AC 548, 577-583 (Lord Goff); *David Securities Pty Ltd v Commonwealth Bank of Australia* (1992) 175 CLR 353, 384-386 (Mason CJ, Deane, Toohey, Gaudron and McHugh JJ). For a discussion of change of position see Chapter 7, 351-353.

<sup>114</sup> *Re Hallett's Estate; Knatchbull v Hallett* (1880) 13 Ch D 696; Ford and Lee, above n 30, [17240]-[17270]; Meagher and Gummow, above n 30, [2709]-[2712].

<sup>115</sup> *James Roscoe (Bolton) Ltd v Winder* [1915] 1 Ch 62.

## 2 The Swollen Assets Theory Undermines the Rateable Distribution

### Principle

Another argument is that swollen assets theory cuts across one of the sacrosanct tenets of insolvency law - the principle of rateable distribution.<sup>116</sup> Scott and Fratcher label the desire to give a creditor priority outside traditional security mechanisms 'a peculiar psychological phenomenon' which can be indulged by writers and judges - to the detriment of general creditors who 'pay the bill'.<sup>117</sup>

The rateable distribution principle has been discussed in Chapter 1.<sup>118</sup> However, the untrammelled operation of the principle of rateable distribution is curtailed. If the principle operated in such a way to determine the rights and liabilities of all creditors, then there would be some merit in the argument that the equality principle was so paramount in determinations of insolvency that there should be no judicial interference to undercut it. However, a cursory examination of the law indicates that rateable distribution is only one of a number of factors which are taken into account when the assets of an insolvent are distributed.<sup>119</sup>

Nevertheless, the underlying assumption is that either the plaintiff to whom fiduciary obligations are owed should access tracing rules or the plaintiff should

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<sup>116</sup> *Bankruptcy Act 1966* (Cth) s 108. For a discussion of this provision see McQuade and Gronow, above n 101, [108.0]-[108.0.15]. In relation to the United Kingdom see *Insolvency Act* (1986) (UK) ss 328(2) (3); Christopher Berry, Edward Bailey, Stephen Schaw-Miller and Philip Reed, *Personal Insolvency-Law and Practice* (1993), 337-344; Ian F Fletcher, *The Law of Insolvency* (2<sup>nd</sup> ed, 1996) 295.

In relation to Canada see *Bankruptcy and Insolvency Act 1950* RSC 1985 c B-3 ss 136 and 141; and L W Houden and C H Morawetz, *The 1996 Annotated Bankruptcy and Insolvency Act* (1996) 323-341; *In the Bankruptcy of Gingras Auto Ltée; Les Produits de Caoutchouc Marquis Inc v Trottier* [1962] SCR 676; 34 DLR (2d) 751.

For a discussion of the situation in relation to unsecured creditors in the United States of America see the Bankruptcy Code which is Title 11 of the *United States Code* (11 USC); Lawrence P King, 'Bankruptcy and Other Insolvency Remedies' in Alan B Morrison (ed), *Fundamentals of American Law* (1996) 463-464; Douglas G Baird and Thomas H Jackson, *Cases, Problems and Materials on Bankruptcy* (1985) 547-573; James W Bowers, 'Bankruptcy' in Alain A Levasseur and John S Baker (eds), *An Introduction to the Law of the United States* (1992) Chapter XXXIII.

<sup>117</sup> Scott and Fratcher, above n 100, vol V § 521, 656. See also Goode above, n 61, 447.

<sup>118</sup> Chapter 1, 32-33.

<sup>119</sup> *Ibid.* Note also in relation to the United States, Baird and Jackson, above n 216, 547-550.

minimise risks by taking security.<sup>120</sup> The problem is that it may not be practical for a party to take security. Swadling<sup>121</sup> has argued that a mistaken payer should not be treated any differently than another unsecured creditor, a victim of a defendant's negligent driving.<sup>122</sup> This view does not take into account that unsecured creditors constitute a wide band of persons and circumstances subject to various legal regimes and remedies. After all, the example of the victim of negligent driving is probably not a good one because the victim would be presumably compensated directly via third party insurance anyway. Nor does it take into account the fact that whilst some parties, such as a victim of a driver's negligence, are creditors based on loss only to themselves, other creditors, such as the mistaken payer, is a creditor because there is a correlation between their commercial loss and the defendant's commercial gain. The net effect of Swadling's attitude is that even if funds are transferred in the course of extraordinary events, an unsecured creditor ought not be elevated to the status of a secured creditor. Instead of facing the problem of differentiating between unsecured creditors, he dismisses their claims completely. Here, Swadling's attitude is really behind the times, even in the light of the House of Lords in the *Westdeutsche* decision, where the House of Lords did enunciate a test for ascertaining priority status in non-fiduciary relationships. The House of Lords recognised that the circumstances surrounding the creation of debt and the status of an unsecured creditor were qualitatively different and may require the imposition of a constructive trust.<sup>123</sup> The problem was that the criteria, presently applied to determine proprietary status, was unnecessarily narrow.<sup>124</sup>

### 3 The Swollen Assets Theory Creates Uncertainty

The third argument is that the swollen assets theory creates uncertainty. In an article on the swollen assets theory, Cowan, Edmunds and Lowry have argued that equitable tracing is now outmoded and needs to be overhauled to take into account

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<sup>120</sup> See generally David S Cowan, Rod Edmunds and John Lowry, 'Equitable Tracing and the Swollen Assets Theory' (1995) 1 *Contemporary Issues in Law* 1. Note also some of the reactions against the remedial constructive trust in the United States in Scott and Fratcher, above n 100, 1996 Supplement, § 481.2.

<sup>121</sup> William Swadling, 'A New Role for Resulting Trusts?' (1996) 16 *Legal Studies* 110.

<sup>122</sup> Ibid 126-127.

<sup>123</sup> [1996] AC 669.

<sup>124</sup> See the discussion in Chapter 3, 129-132.

the modern commercial needs.<sup>125</sup> They examined the swollen assets theory as an alternative to the equitable tracing rules and they decided that its scope was too wide. They argued that its operation was neither limited to fiduciary relationships nor to the identification of specific assets. The result was the potential destruction of the line between personal and proprietary remedies.<sup>126</sup> This sentiment is shared by other commentators.<sup>127</sup> However, Cowan, Edmunds and Lowry rejected the swollen assets theory without asking one fundamental question - under what circumstances did the courts in the United States grant proprietary relief under the swollen assets theory? These authors did not undertake an examination of the American case law. If these authors had done so, then their final appraisal of the swollen assets theory may have been different - although it is conceded that the theory did challenge the artificial divide between personal and proprietary relief.

### ***D Extending Proprietary Relief for Breach of Fiduciary Duty Beyond Traceable Proceeds***

The swollen assets theory has presaged two possible areas of proprietary expansion.

#### ***1 Extensions of Remedial Relief in Commercial Relationships Regulated by Fiduciary Obligations***

There were those situations where the theory was used as a modern extension of equitable tracing. The sorts of cases which arose involved the misappropriation of assets by a fiduciary because the fiduciary used the money to pay his own debts,<sup>128</sup> the running of his own business<sup>129</sup> and sometimes because the asset had been in fact acquired by a third party which was aware of the breach.<sup>130</sup> The sorts of parties

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<sup>125</sup> See generally Cowan, Edmunds and Lowry, above n 120.

<sup>126</sup> Ibid 20.

<sup>127</sup> Burrows, n 2, 44-45; Goode, above n 61.

<sup>128</sup> See for example the early cases of *McLeod v Evans* 28 NW 173 (SC Wisconsin, 1886); *Myers v Board of Education of City of Clay Center* 32 P 658 (SC Kansas, 1893).

<sup>129</sup> *Nelson v McLean's Estate* 161 SW (2d) 676 (Kansas Court of Appeals, 1942); *Horigan Realty Company v Flynn* 253 SW 403 (Kansas Court of Appeals, 1923).

<sup>130</sup> *Evangelical v Synod of North America v Schoeneich* 45 SW 647 (SC Missouri, 1898).

which fell under the category were trustees<sup>131</sup> and treasurers of corporations who acted without authority.<sup>132</sup> However, the funds were untraceable.

If a trustee misappropriates the trust assets for his own use or diverts them to a third party who is aware of the trust status of the funds, why should equitable tracing limit the beneficiary's remedies? The beneficiary has not assumed the risk of the wrongdoing of the insolvency of the trustee or the third party. In order to justify the obvious limitations of equity's tracing rules, one author has suggested that beneficiaries and bailors do take on the risk of insolvency and therefore this is not a sufficient rationale for the expansion of the beneficiary's and bailor's proprietary reach beyond traceable assets.<sup>133</sup> With respect, such a suggestion fails to take into account that a beneficiary under a trust may have no input into the appointment of that trustee. Therefore, it could not be said that the beneficiary has assumed the risk of the insolvency of the trustee. Moreover, equity has determined that proprietary intervention is required to protect the interests of beneficiaries due to the trust and confidence reposed in the trustee. The entire relationship is antithetical to the practical taking of risk. The argument in relation to bailors can be dispensed with quickly. The essential nature of bailment is that the bailor retains the legal and equitable proprietary interest in the assets.<sup>134</sup> It is for that reason that the goods stand outside the insolvent bailee's estate.

Therefore, a practical result of equitable tracing may be the dilution of the beneficiary's interest in the general assets of the fiduciary. The swollen assets theory permits the beneficiary to claim his proprietary interest against the whole of the assets of the fiduciary<sup>135</sup> and it represents an extension to equitable tracing. If the swollen assets theory is re-appraised as the logical and coherent culmination of the equitable tracing rules rather than the destroyer of them, the inner logic of the

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<sup>131</sup> *McLeod v Evans* 28 NW 173 (SC Wisconsin, 1886); *Evangelical v Synod of North America v Schoeneich* 45 SW 647 (SC Missouri, 1898) and the authorities cited therein at 650.

<sup>132</sup> *Davenport Plow Co v Lamp* 45 NW 1049 (SC Iowa, 1890); *Independent District v Boyer v King* 45 NW 908 (SC Iowa, 1890); *Myers v Board of Education of City of Clay Center* 32 P 658 (SC Kansas, 1893).

<sup>133</sup> Smith, above n 2, 313-314.

<sup>134</sup> *Davis v Heuber* (1923) 31 CLR 583, 595 (Higgins J).

<sup>135</sup> cf *American Express Co v Cochrane* 137 So 696 (SC Florida, 1931) for a situation where the preferred claim was limited to cash assets.

swollen assets theory becomes apparent. Swollen assets theory extends equity to secure the rights and interests of beneficiaries which the present equitable tracing do not protect. A failure to protect those interests results in the absurd result that an insolvent trustee may benefit from the misappropriation of trust funds where he has sufficiently muddled the tracing waters. As the Supreme Court of Missouri stated in *Orr v St Louis Union Trust Co*:<sup>136</sup>

It would indeed be strange doctrine that a trustee can accept money or other property in trust, and, by commingling such property with his own in hopeless confusion, defeat the very object and purpose of the trust. Such a rule would violate one of the cardinal principles of the law, that no man may take advantage of his own wrong.<sup>137</sup>

## ***2 Intervention in Commercial Relationships which are not Regulated by Fiduciary Obligations***

The swollen assets theory was applied to situations where the relationship of the parties was not fiduciary (in the sense that they were not characterised as automatically fiduciary). Oesterle<sup>138</sup> pointed that:

The high-water mark of tracing came in the early 1930's when depositors in numerous bank failures found their accounts empty and were unable to trace their funds into any identifiable fund or property of the insolvent bank. The depositors were left to squabble among each other and with the bank's other creditors for a share of the remaining assets. Courts in a few states, moved by the plight of some of the victims recognised a 'swollen asset' or 'augmentation' theory of tracing that gave those select depositors priority over other kinds of creditors...Under the new theory, if the plaintiff could prove some equitable wrong by the bank against him, he was excused from specifically tracing his lost funds into products of exchanges or into commingled funds. The mere fact that the bank wrongfully dealt with

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<sup>136</sup> 236 SW 642 (SC Missouri, 1922). See also *Nelson v McClean's Estate* 161 SW (2d) 676 (Kansas City Court of Appeals, 1942) which cited and followed this case. Note also *First Trust Co of Lincoln v Exchange Bank* 254 NW 569 (SC Nebraska, 1934).

<sup>137</sup> Ibid 649.

<sup>138</sup> Oesterle, above n 80.

the plaintiff's assets entitled him to an equitable lien on the bank's entire estate for the full amount of the loss.<sup>139</sup>

Scott and Fratcher argued that it would be incorrect to base priority on the character of the wrong because it:

would seem to be unjust to the general creditors, and no court has gone so far as to base priority merely upon the character of the wrong done.<sup>140</sup>

At this point, Scott and Fratcher have shown that the swollen assets theory never operated solely on the basis of the defendant's wrong without recourse to the issue of whether the defendant's assets had been augmented initially. To this extent, Scott's evaluation was correct. But the effect of such an assertion has been to underestimate the context in which a defendant received money which courts did examine closely.

This attitude towards the award of proprietary relief is no longer tenable. As shown in Chapter 3,<sup>141</sup> it leads to the unsatisfactory use and abuse of the law of fiduciary obligations.

Moreover, linked to the fiduciary pre-requisite issue, there has been an unnecessary bifurcation of rules in common law and equity. This problem has been ably raised by Smith<sup>142</sup> who has shown that the development of common law following (which does not have a fiduciary pre-requisite) was unnecessarily limited by early case law.<sup>143</sup> There can be no doubt that the existence of two regimes has led to the unnecessary complexity. Where Smith's argument and underlying theme of this thesis diverge is the remaining importance of equity as the primary determinant of proprietary relief and the role of the swollen assets theory. Smith contends that common law following (which for Smith is essentially a mechanical process) would operate in much the same way as the present rule of equitable tracing without the

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<sup>139</sup> Ibid 189 fn 33.

<sup>140</sup> Scott and Fratcher, above n 100, vol V, § 521.

<sup>141</sup> Chapter 3, 122-125.

<sup>142</sup> Smith, above n 2, 120-130.

<sup>143</sup> Ibid 162-174; Lionel D Smith, 'Tracing in *Taylor v Plumer*: Equity in the Court of King's Bench' [1995] *Lloyds Maritime and Commercial Law Quarterly* 240.

need for equity's fiduciary pre-requisite. However, there would be no need for the adoption of the swollen assets theory. Therefore, the common law could make a proprietary response to unjust enrichment without the need to consider equitable principles. Instead, this thesis asserts that proprietary relief ought to be linked to equitable principles and that those principles can regulate the application of the swollen assets theory.

The retention of the fiduciary pre-requisite would mean that there would be situations where the insolvent non-fiduciary could act with impunity and the plaintiff would not be entitled to any proprietary relief. As equity has re-emerged in the late 20th century, the limitations which were placed on the operation of equitable tracing are no longer sensible. There will be situations which are not governed by fiduciary obligations where equitable proprietary relief is merited because our modern notion of unconscionable conduct demands it.

Finally, Oesterle's presentation of the remedy available for an aggrieved depositor was correct, in so far that it represented the swollen assets theory at its broadest and most effective. However, the description also suggested that the theory (unrestrained by the fiduciary pre-requisite) was applied generously in favour of commercial depositors. An examination of the case law indicates that this was not so.

Whilst some commercial parties were accorded proprietary rights analogous to a beneficiary's interest in a trust, some courts held that the plaintiff was only entitled to trace as a beneficiary if it were possible to identify the assets<sup>144</sup> and/or the bank's assets were currently augmented.<sup>145</sup> Therefore, the comprehensive swollen assets theory was not available in all cases. However, there were four situations in which courts apparently intervened and provided relief to a customer who would have otherwise been left to pursue personal remedies.<sup>146</sup> These situations could not be interpreted as opening up an unmanageable or uncertain collection of exceptions

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<sup>144</sup> *Woco Pep Co v Montgomery* 149 So 692 (SC Alabama, 1933); *Tri-Lake Const. Co v Northam* 184 NE 792 (Appellate Court Indiana, 1933); *School District No 62 v Schramm* 20 P (2d) 241 (SC Oregon, 1933).

<sup>145</sup> *Burnes National Bank of St Joseph Mo v Spurway* 28 F (2d) 40 (District Court Iowa, 1928); *National Bank of the Republic v Porter* 258 P 544 (SC Idaho, 1927); *Kansas State Bank v First State Bank of Marrion* 64 P 634 (SC Kansas, 1901); *Kershaw v Jenkins* 71 F (2d) 647 (10<sup>th</sup> Cir, 1934); *Edisto National Bank of Orangeburg SC v Bryant* 72 F (2d) 917 (4<sup>th</sup> Cir, 1934). A modern example is *Chase Manhattan NA v Israel-British Bank (London) Ltd* [1981] Ch 105.

<sup>146</sup> For a discussion of some of these situations see Hirsch, above n 79, 12-13.



to the principle of rateable distribution. Hirsch has referred to these kinds of situations as those in which the defendant was characterised by the courts as being a trustee *ex maleficio*.<sup>147</sup> A trustee *ex maleficio* is:

A person who, being guilty of wrongful or fraudulent conduct, is held by equity to the duty and liability of a trustee, in relation to the subject-matter, to prevent him from profiting by his own wrongdoing.<sup>148</sup>

Courts utilised swollen assets theory to ensure that a wrongdoer did not profit from wrongdoing.

### ***(a) Accepting Deposits When Insolvent.***

Prior to the Depression, courts took a dim view of banks which accepted deposits in the knowledge that the bank was hopelessly insolvent. Courts had held that the relationship of debtor and creditor did not arise but instead, such an act constituted a fraud and the customer was entitled to a preferential claim.<sup>149</sup> This position did not change during the Depression. There were a number of cases in which the courts accorded a plaintiff a proprietary remedy or discussed the possibility of a plaintiff being accorded such a remedy.<sup>150</sup> These cases arose in the context of the transfer of money,<sup>151</sup> deposits<sup>152</sup> and the collection of cheques.<sup>153</sup> There were three main requirements.

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<sup>147</sup> Ibid.

<sup>148</sup> Henry Campbell Black, *Black's Law Dictionary* (6<sup>th</sup> ed, 1990) 1514.

<sup>149</sup> See for example *Richardson v New Orleans Coffee Co Ltd* Co 102 F 780 (5<sup>th</sup> Cir, 1900).

<sup>150</sup> *Scharnberg v Citizens National Bank of Spencer, Iowa* 33 F (2d) 673 (8<sup>th</sup> Cir, 1929); *Great Atlantic and Pacific Tea Co. v Citizens National Bank* 2 Fed Supp 29 (District Court Pennsylvania, 1932); *Florida Bank and Trust Co v Yaffey* 136 So 399 (SC Florida, 1931); *Cameron v Carnegie Trust Co* 140 A 768 (SC Pennsylvania, 1928); *Lipchutz v Philadelphia Saving Fund Society* 164 A 74 (SC Pennsylvania, 1933); *Tri-Lake Co v Northam* 134 NE 792 (Appellate Court Indiana, 1933).

<sup>151</sup> *Scharnberg v Citizens National Bank of Spencer, Iowa* 33 F (2d) 673 (8<sup>th</sup> Cir, 1929).

<sup>152</sup> *Great Atlantic & Pacific Tea Co v Citizens' National Bank* 2 F Supp 29 (District Court Pennsylvania, 1932).

<sup>153</sup> *Cameron v Carnegie Trust Co* 140 A 768 (SC Pennsylvania, 1928); *Lipschutz v Philadelphia Savings Fund Society* 164 A74 (SC Pennsylvania, 1933).

First, the defendant had to be insolvent. For some courts this meant that the defendant must be in the situation that there was no possibility that it could save itself from the desperate financial predicament.<sup>154</sup> The Court stated in *Quin v Earle*:<sup>155</sup>

But fraud must be proved, and is not to be presumed, and the burden of proof is on the complainant. The mere fact that the bank was in an embarrassed condition, by reason of the large indebtedness to it from its president, is not sufficient of itself to establish fraud in this case. A trader, whether a corporation or an individual, may be struggling in the straits of financial embarrassment, but with an honest hope of weathering the financial storm and of being eventually solvent. Property received by such an individual or concern in the ordinary course of business during the period of such embarrassment becomes honestly theirs, and the fact that their expectations were unrealised, and their hopes not well founded, would not fasten upon them a fraud that would vitiate their business transactions.<sup>156</sup>

Such a requirement neither undermined the rule that generally customers have a personal remedy against the bank, nor undercut rateable distribution. The financial institution took funds in circumstances where it was impossible for it to repay an equivalent amount to the depositor.

Hirsch<sup>157</sup> suggested that a less strict approach was applied as well. He pointed out that some courts have held that a plaintiff was successful on the basis that the defendant bank was 'unable to meet its current obligations as they mature.'<sup>158</sup> Another way of describing the test was:

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<sup>154</sup> *Great Atlantic & Pacific Tea Co v Citizens' National Bank* 2 F Supp 29 (District Court Pennsylvania, 1932), 32.

<sup>155</sup> 95 F 728 (Circuit Court Pennsylvania, 1899). This case was cited and quoted with approval in *Great Atlantic & Pacific Tea Co v Citizens' National Bank* 2 F Supp 29 (District Court Pennsylvania, 1932), 32.

<sup>156</sup> *Ibid* 732.

<sup>157</sup> Hirsch, above n 79, 12 fn 5.

<sup>158</sup> *Ibid* citing *Florida Trust Co v Yaffey* 136 So 399 (SC Florida, 1931); *Griffin v State* 83 SE 891 (Court of Appeals Georgia, 1914); *Commonwealth v Tradesmen's Trust Co* 85 A 363 (SC Pennsylvania, 1915).

insolvency in its legal sense, which exists whenever such an institution as this, from any cause, is unable to pay its debts in the ordinary or usual course of its business.<sup>159</sup>

In many cases, the circumstances of the case would fulfil both the tests enunciated in *Quin v Earle* and the legal definition of insolvency. The question is whether there was any significant difference between the two approaches. A qualitative difference may exist in relation to the actual amount of money which the debtor owes and whether there was a prospect (however negligible) that the business may be rescued. And it can be argued that the financial embarrassment was not the same as legal insolvency because the former was a temporary aberration in the liquidity of the bank (and a manifestation of a practical incapacity to pay) rather than the lack of sufficient assets to discharge the debt. But, that is a fine line and should not be overstressed to the detriment of a plaintiff. What the two different approaches showed was that the access to proprietary relief was limited to situations where the defendant was actually insolvent at the time the payment is made.

Secondly, the relevant officers had to know that the bank was insolvent. This principle had been articulated in *Quin v Earle*<sup>160</sup> and was applied in other cases as well.<sup>161</sup> The problem with this criterion is whether it was necessary that the officer knew that the bank was insolvent or whether it was adequate that the officer had sufficient knowledge to indicate that he ought to have been aware of the insolvency. It is arguable that the complexity of showing these factors could justify the conclusion that, although the criteria leading to the application of the swollen assets theory was limited, there was still great uncertainty. However, the appropriate reply is that these matters raised evidential problems more than they raise problems of the clarity of the general principle. Unfortunately, the cases are not decisive. Generally, it was unnecessary to consider the proof of knowledge because the officers were found to have known of the insolvency anyway. Even where the question of

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<sup>159</sup> *Commonwealth v Tradesmen's Trust Co of Philadelphia* 85 A 363 (SC Pennsylvania, 1915), 364. See also Section 40 *Bankruptcy Act 1966* (Cth) for the kinds of situations where an act of insolvency will occur. For a general discussion see Dennis Rose in *Lewis: Australian Bankruptcy Law* (10<sup>th</sup> ed, 1994) Chapters 5 and 6.

<sup>160</sup> 95 F 728 (1899), 732.

<sup>161</sup> *Scharnberg v Citizens' National Bank of Spencer, Iowa* 33 F (2d) 673 (8<sup>th</sup> Cir, 1929); *Cameron v Carnegie Trust Co* 140 A 768 (SC Pennsylvania, 1928); *Corn Exchange National Bank v Solicitors' Loan & Trust Co* 41 A 536 (SC Pennsylvania, 1898).

knowledge was raised,<sup>162</sup> the defendant did not present sufficient evidence to show that he did not have knowledge of the insolvency. He simply denied the allegation whilst there was ample evidence which indicated knowledge on his part.<sup>163</sup> It may well be that the fact that the institution continued trading when management was aware of the appalling financial situation would be sufficient to meet such a knowledge requirement. After all, the continued trading in cases of insolvency would constitute a misrepresentation of financial worthiness. Whether the bank clerk who handled the mundane aspects of the transaction actually knew of the insolvency would probably be irrelevant if the institution continued trading and the controlling office bearers were aware of the insolvency.

Thirdly, the depositor or forwarder of the cheques for collection was not be aware of the insolvency of the defendant bank. This is not specifically articulated in the case law. But, it is understood that a party cannot be accused of fraud in these circumstances when a depositor does know (or has good reason to know) that the bank is insolvent. Another way of stating this is that the plaintiff did not know of the insolvency and presumed that the bank was solvent and operating in the ordinary course of business. As the condition of the defendant was otherwise, the plaintiff had not assumed the risk of the defendant's pre-existing insolvency. The appropriate course of action for the bank was either to refuse to accept the deposit or cheque, or, on acceptance, to segregate the funds from the bank's other cash assets.<sup>164</sup>

### ***(b) Failure to Honour a Depositor's Cheque on Presentation***

Courts granted proprietary relief on the basis that there has been a failure of a bank to honour the depositor's cheque on presentation, whilst the bank was still solvent.<sup>165</sup> Courts held that it was the duty of the bank to make payment on the

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<sup>162</sup> *Cameron v Carnegie Trust Co* 140 A 768 (SC Pennsylvania, 1928).

<sup>163</sup> *Ibid* 770.

<sup>164</sup> *Lipchutz v Philadelphia Saving Fund Society* 164 A 74 (SC Pennsylvania 1933), 76.

<sup>165</sup> *Koehler v Joplin State Bank* 68 SW (2d) 728 (Springfield Court of Appeals, Missouri, 1934); *Claxton v Cantley* 297 SW 975 (Springfield Court of Appeals, Missouri, 1927).

cheque from the account.<sup>166</sup> In *Johnson v Farmers' Bank of Clarksdale*<sup>167</sup> the Court considered this situation stating:

If it be conceded that the deposit was general, thus creating the relation of debtor and creditor, such relation was changed when the \$3200 check was drawn by plaintiff against such deposit and presented to defendant bank for payment. At that time plaintiff had on deposit, and the bank had on hand and on deposit in the First National Bank of St Joseph, sufficient money with which to pay the check. It was the defendant's duty to pay the check....It being defendant's duty to pay the check, after its refusal so to do it held the amount of the check as trustee... It would be unjust to permit plaintiff to suffer loss, or permit the other creditors of the bank to profit by the wrongful act of the bank in refusing to pay plaintiff's check when presented.<sup>168</sup>

The result was that, although the money had not been segregated and was not traceable under orthodox principles, the depositor could obtain a preferential interest in the assets of the bank for the amount of the cheque.

In *Bryan v Coconut Grove Bank & Trust Co*<sup>169</sup> the Supreme Court of Florida held that the plaintiff's interest was elevated to that of a special deposit<sup>170</sup> and the plaintiff's preferential interest extended to all of the assets of the defendant:

That the funds thus held upon special or specific deposit improperly remained commingled with the general funds belonging to the bank by reason of the failure of the bank's officers to segregate the funds as it was their duty to do, does not defeat appellant's title to such funds merely because there is no way to identify the specific money. The mingling of such specific funds under those circumstances extends the trust to all the funds of the bank.<sup>171</sup>

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<sup>166</sup> *Claxton v Cantley* 297 SW 975 (Springfield Court of Appeals, Missouri, 1927); *O'Grady v Stotts City Bank* 80 SW 696 (St Louis Court of Appeals, 1904); *Allen Grocery Co v Bank of Buchanan County* 182 SW 777 (Kansas City of Court of Appeals. 1916)

<sup>167</sup> 11 SW (2d) 1090 (Kansas City Court of Appeals, 1928).

<sup>168</sup> *Ibid* 1091.

<sup>169</sup> 132 So 481 (SC Florida, 1931).

<sup>170</sup> See below, 173-174.

<sup>171</sup> 132 So 481 (SC Florida, 1931), 487.

In the light of commercial risk assumption, it could be said that upon the presentation of the cheque to the defendant banks, the risk which the plaintiff had willingly accepted as a depositor in the bank came to an end. The failure of the bank, whilst still in a solvent state, to accede to the request did not affect the legal and practical consequences of the depositor's legal act. The debtor-creditor relationship had come to an end. The bank was no longer entitled to use the money as its own. The relationship had irrevocably changed from one based on debt and common law to one regulated by equity.<sup>172</sup>

### **(c) Safekeeping**

Hirsch<sup>173</sup> argued that, where a bank has securities deposited with it for safe keeping and converted those securities and used the proceeds for its own use, then the bank was a trustee *ex maleficio*. The problem with Hirsch's account was that some of the authorities to which he referred supported his general conclusion but they did not apply the swollen assets theory. Instead, orthodox tracing rules were applied<sup>174</sup> Other cases concerned parties, other than depositors and banks, in the context of other actions such as theft.<sup>175</sup> However, the authorities were helpful in the sense that they make it clear that persons who stole property or received stolen property with knowledge<sup>176</sup> or stole property from their employer and invested it in property<sup>177</sup> were held liable as trustees. They could not swell their assets from their own wrongdoing. In the context of the underlying theme of the thesis, a party from whom money is stolen, did not assume the risk of the insolvency of the thief.<sup>178</sup> So too, depositors of securities with banks for safekeeping did not bear the risk of wrongdoing or the risk of insolvency.

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<sup>172</sup> Ibid 484-485.

<sup>173</sup> Hirsch, above n 79, 13.

<sup>174</sup> *Re Royersford Trust Co* 178 A 288 (SC Pennsylvania, 1935), 289-290.

<sup>175</sup> *Fur & Wool Trading Co Ltd v George I Fox* 156 NE 670 (Court of Appeals New York, 1927).

<sup>176</sup> Ibid 671.

<sup>177</sup> *Preston v Moore* 180 SW 320 (SC Tennessee, 1915); *Nebraska National Bank v Johnson* 71 NW 294 (SC Nebraska, 1897).

<sup>178</sup> Chapter 6, 225-227.

#### *(d) Special Deposits and General Deposits for a Special Purpose*

In addition to the specific example raised by Hirsch, there were also those cases which were categorised (and are still categorised) by courts in the United States as giving rise to special deposits and deposits for purposes. The former case was where the depositor entrusted chattels, securities or money with a bank which were to be held separately from the bank's assets and not to be used by the bank as part of its own assets.<sup>179</sup> The depositor, like the safekeeping category above, was not simply a general creditor of the bank<sup>180</sup> and was entitled to trace the property into the assets of the bank.

General deposits for purposes were those situations where the bank undertook to apply money deposited with it in a way which the depositor specifically directed. Therefore, it can be said that the depositor did not take on the risk of the bank's financial position, but rather used the bank as a conduit or agent to perform a task on the depositor's behalf. Both prior to and during Depression years, courts held that the deposit made for a general purpose entitled the depositor to priority over the general creditors of the bank in the event of the bank's insolvency. There were many purposes<sup>181</sup> which the courts accepted as giving rise to a trust under which tracing rules could be used to ascertain property, including security for the performance of a contract,<sup>182</sup> deposits for the payment of personal or real property,<sup>183</sup> deposits for investment in particular investment schemes<sup>184</sup> and deposits for payment of indemnities to guarantors.<sup>185</sup> However, there were a large number of cases<sup>186</sup> which

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<sup>179</sup> Scott and Fratcher, above n 100, vol VA, §530.

<sup>180</sup> Ibid. See also *Bloomheart v Foster* 221 P 279 (SC Kansas, 1923); *State v Bunton* 285 SW 98 (SC Missouri, 1926) and *Gwynn v Spurway* 28 F (2d) 37 (District Court Iowa, 1928).

<sup>181</sup> Scott and Fratcher, above n 100, vol VA, §530.

<sup>182</sup> *City of Miami v Shutts* 51 So 929 (SC Florida, 1910); *Woodhouse v Crandall* 64 NE 292 (SC Illinois, 1902).

<sup>183</sup> *Interstate Trust & Banking Co v Jones County, Miss.* 77 F(2d) 806 (5<sup>th</sup> Cir. 1935); *Peoples-Ticonic Bank v Stewart* 86 F (2d) 359 (1st Cir, 1936); *Rossmann v Blunt* 104 F (2d) 877 (6<sup>th</sup> Cir, 1939); *Shoptert v Indiana National Bank* 83 NE 515 (Appellate Court Indiana, 1907).

<sup>184</sup> *Harrison v Smith* 53 Am Rep 571 (SC Missouri, 1884).

<sup>185</sup> *Marshall v Farmers & Merchants Bank of Steele* 253 SW 15 (Springfield Court of Appeals Missouri, 1923).

<sup>186</sup> For a full description see Scott and Fratcher, above n 100, vol VA, §530.

were described as general deposits for purposes in which the courts held that the depositor did not acquire a priority over the general creditors of the bank. It is evident that not all courts were willing to impose trust obligations in what were otherwise general deposits.<sup>187</sup> Moreover, despite the description of the purpose, the evidence was not sufficiently clear to show that the depositor did not intend that the bank should use the money as its own.<sup>188</sup> Cases have suggested that what was at issue was whether or not there was a mutual understanding or agreement on the part of the bank and the depositor that the money could only be allocated for the specific purpose.<sup>189</sup> If the deposit had been made on terms that the bank could not use the money as its own, then the depositor had not taken on the risk of the bank's insolvency.

### ***3 Evaluation of the Swollen Assets Theory***

An analysis of the swollen assets theory indicates that it neither created uncertainty nor did it expand the proprietary net unduly. The underlying theme of the swollen assets theory was wrongdoing. If there had been a breach of fiduciary relationship and the funds could not be traced under orthodox tracing principles, then swollen assets theory provided a means by which the plaintiff could access proprietary relief. The swollen assets theory did not overturn equitable tracing. Rather it was the logical culmination of tracing rules which were overtaken by technological developments and economic chaos.<sup>190</sup>

Where there was no fiduciary obligation imposed on the parties, intervention was on a limited and principled basis. The question here again was whether the conduct of the defendant bank was tantamount to wrongdoing. And, indeed, it could not be said that the situations where proprietary relief was awarded were controversial or unreasonable. The courts were careful not to haphazardly extend proprietary relief beyond what was considered absolutely necessary. It has been

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<sup>187</sup> *Northern Sugar Corporation v Thompson* 13 F (2d) 829 (8<sup>th</sup> Cir. 1926) and the authorities cited therein at 831-832.

<sup>188</sup> Scott and Fratcher, above n 100, vol VA, §530, 8.

<sup>189</sup> *Rossman v Blunt* 104 F (2d) 877 (6<sup>th</sup> Cir, 1939); cf *Killoren v First National Bank in St Louis* 127 F (2d) 537 (8<sup>th</sup> Cir. 1942); *Fallgatter v Citizens National Bank* 11 F (2d) 383 (District Court Minnesota, 1926). For a discussion of special purpose in the context of mutual intention to create a trust see Chapter 3, 112-114.

<sup>190</sup> Note in this context Taft, above n 73, 176-178.



demonstrated that in each of the situations discussed, it could be shown that the plaintiff did not bear the risk of an unsecured status in the event of the defendant's insolvency.

## V CONCLUSION

The assumption that there must be a proprietary base before proprietary relief will be awarded is seriously under challenge. The manipulation and extension of following and tracing rules to accommodate the dynamics of commercial transactions must eventually lead to the conclusion that the pre-condition of a proprietary base is unnecessary and unworkable. The swollen assets theory presaged the increasing unworkability of the proprietary base theory.

It is feared that the swollen assets theory would lead to uncertainty. But, the historical material has shown that outside the traditional realm of fiduciary obligations, swollen assets theory was applicable only in a few circumstances where equity deemed a bank to be a *ex maleficio*. It did not open the proprietary net widely.

What the swollen assets theory did accomplish was a re-orientation of the analysis away from technical questions of whether or not the funds were still traceable into the hands of the defendant, to an evaluation of the nature and extent of the obligations between those parties. Whilst courts were freed from the mechanical constraints, they revisited (albeit intuitively) the values inherent in equitable tracing - risk assumption and unconscionable conduct.

Today, the swollen assets theory is the bridge between the orthodox proprietary view and a new approach to proprietary relief discussed in Part Two.

## **PART TWO**

### **A THEORY OF OBJECTIVE NON-ASSUMPTION OF RISK**

## **Chapter 5**

### **EQUITY'S DOMAIN: UNCONSCIONABLE CONDUCT AND PROPRIETARY RELIEF**

## I INTRODUCTION

In Part One, the traditional gateways by which equity recognised and imposed proprietary interests and relief were considered. The traditional relationships which were discussed in Chapter 2 were cases where courts exercising equitable jurisdiction had found equitable proprietary interests or imposed equitable proprietary relief on the basis of the equitable notion of conscience.<sup>1</sup> In Chapter 3, various means by which the traditional gateways have been manipulated by courts and commentators alike were discussed. It was argued in that chapter that some extensions have been utilised without appreciation of the underlying concepts of conscience and risk assumption which inform them. The result has been unnecessary ambiguity and uncertainty.

The function of Part Two is to delineate the basis upon which equitable proprietary intervention should take place. In this chapter, it will be contended that equity sustains the appropriate principles upon which proprietary relief ought to be granted. It will be argued that the determination of when equitable proprietary relief is available (outside well established categories) is inextricably bound up with an understanding of unconscionable conduct (or unconscionability). Unfortunately, this fundamental proposition has been lost amidst the confusion created by different labels and recent theories posited by English restitution lawyers. This chapter will commence with an analysis of the limitations of the mutual intention approach. Thereafter, unconscionable conduct will be identified and described in order to show the breadth and flexibility of the principle. However, it will be argued that equity's inherent flexibility does not create unnecessary uncertainty or provide an avenue for the application of subjective notions of fairness and justice. Unconscionability has real and concrete meaning in equitable jurisprudence. The relationship of unconscionable conduct and unjust enrichment is also considered. Finally, the chapter is devoted to a theoretical analysis of how unconscionable conduct may contribute to a creditor's non-assumption of the risk of the status of an unsecured creditor. It is argued that proprietary intervention is warranted when it can be shown that the unconscionable conduct had a causal connection to the creditor's unsecured status; and, the creditor could not be expected to minimise the risk of the commercial transaction. This is referred to as the theory of objective non-assumption of risk.

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<sup>1</sup> For a discussion of the notion of conscience in equity see Patrick Parkinson, 'The Conscience of Equity' in Patrick Parkinson (ed), *The Principles of Equity* (1996) 28.

Chapter 6 constitutes a practical and non-exhaustive application of the theory of objective non-assumption of risk. It describes the kinds of situations where equity does, and ought to, intervene and provide proprietary relief on the basis of non-assumption of risk. In order to do so, it sets out certain market contexts which may indicate inherently that the creditor was, or was not, expected to minimise the risk of the commercial transaction. Thereafter, various kinds of unconscionable conduct are considered with a view to determining when equitable proprietary relief would be appropriate.

Chapter 7 delineates the kind of device equity ought to use when providing proprietary relief and the possible defences open to an insolvent and insolvency administrators. Equity has been highly creative in its remedial response to unconscionable conduct. It will be argued that where monetary transactions are involved in the insolvency context, a general equitable lien is preferable, even to the constructive trust. The history and traditional function of the equitable lien is considered in order to sustain the argument in its favour. However, a general equitable lien is still a theoretical construct in our law. Accordingly, a portion of the chapter is devoted to defining the general equitable lien, the potential operation of a general equitable lien and the policy issues which it foreshadows. Thereafter, possible defences to an action based on an objective non-assumption of risk are outlined.

## **II THE LIMITATIONS OF THE MUTUAL INTENTION APPROACH**

The mutual intention cases are a starting point for a determination of when and how equity ought to intervene in commercial transactions. It will be recalled that the mutual intention cases are those situations where two parties have mutual intention that funds should not form part of the assets of the recipient.

Where there is a requirement and/or actual segregation of the assets, then courts have been willing to find that there has been a mutual intention to create a trust.<sup>2</sup> However, where there has been no segregation of assets, the question is whether a party has another basis upon which to argue entitlement to proprietary relief.

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<sup>2</sup> Chapter 3, Part III.

The need for a shift from an intention based orientation of trust creation to an evaluation and application of unconscionable conduct, began to arise in the common intention cases dealing with de facto relationships and trusts. For example, in *Allen v Snyder*<sup>3</sup> Glass JA held that courts could find that a trust regulated the ownership of a house where a couple lived and where the title was registered in the name of one party. Glass JA held that a court would find that the parties had created a trust in favour of the unregistered party, where the parties had expressed a common intention orally or where the conduct of the parties was such that it could be inferred from their conduct.<sup>4</sup> His Honour drew a distinction between inferring an intention from the conduct of the parties and imputing intention. The former method was appropriate because, from the conduct of the parties, it was possible to infer their subjective intention as the basis of the express trust.<sup>5</sup> However, Glass JA rejected the view that imputation of intention to create a trust was possible, that is, attributing intention without tangible evidence of such intention.<sup>6</sup> It was held that the woman in the de facto relationship failed to provide evidence from which a subjective mutual intention to create a trust could be drawn. The outcome of the case was criticised, inter alia, because it did not 'do equity in such cases.'<sup>7</sup>

In the absence of the segregation of funds or assets, the common intention cases drew attention to the difficulty of inferring intention from the acts and statements of parties and the fine line between inferring intention and imputing intention. How could it be said with certainty that certain kinds of financial arrangements or activities indicated an intention to create a trust to the exclusion of others? Surely, in identifying certain financial arrangements as indicative of intention, the court was making its own judgement as to what parties in a de facto

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<sup>3</sup> [1977] 2 NSWLR 685. See also *Pettit v Pettit* [1970] AC 777; *Gissing v Gissing* [1971] AC 886; *Kardynal v Dodek* [1980] FLC ¶90-823; *Hohol v Hohol* [1981] VR 221; *Kelly v Price-Williams* (1982) 8 Fam LR 665; *Butler v Caine* [1986] VR 274; *Cooke v Cooke* [1987] VR 625; *Higgins v Wingfield* [1987] VR 689; *Green v Green* (1989) 17 NSWLR 343; *Grant v Edwards* [1986] 638; *Lloyd's Bank plc v Rosset* [1991] 1 AC 107; *Hammond v Mitchell* [1992] 2 All ER 109.

<sup>4</sup> [1977] 2 NSWLR 685, 690-691.

<sup>5</sup> Ibid 690.

<sup>6</sup> Ibid. See also *Cook v Fountain* (1673) 3 Swans 585, 592; 36 ER 984, 987 (Lord Nottingham).

<sup>7</sup> Patrick Parkinson, 'Doing Equity between De Facto Spouses: From *Calverley v Green* to *Baumgartner*' (1988) 11 *Adelaide Law Review* 370; Marcia Neave, 'Living Together - The Legal Effects of the Sexual Division of Labour in Four Common Law Countries' (1991) 17 *Monash Law Review* 14, 30.

relationship should do in order to evince an intention to create a trust. The attempt to characterise the trust which arose, showed that the orthodox method of differentiating trusts on the basis of intention was becoming increasingly unhelpful. Indeed, some judges treated common intention trusts as express trusts.<sup>8</sup> Some opined that the trust was in reality a constructive trust based on detrimental reliance on the common intention,<sup>9</sup> whilst others viewed the arguments based on detrimental reliance as incorrect.<sup>10</sup> Some commentators have noted that there may be a progressive connection between common intention trusts and resulting trusts.<sup>11</sup>

The common intention trust was not the province of de facto relationships solely. In the absence of the segregation of assets, commercial parties sought to argue that a mutual intention to create a trust re-adjusted proprietary interests. The problems associated with arguing mutual intention in the de facto cases were apparent in them also. In *Canadian Commercial Bank and Paristyle Novelty Co Ltd and Sheen's for Shoes Ltd v RT Holman Ltd*<sup>12</sup> an insolvent company, Holmans, was the head tenant in a building complex to which rental payments were forwarded by other sub-tenants, such as Paristyle. The rental payments were deposited and intermingled in an operating account. Holmans was required to remit the payments to the landlord. During the insolvency proceedings, the question was whether a trust operated in favour of the sub-tenants for the rental payments. McQuaid J held that a trust did not operate in favour of the sub-tenants. In the absence of the segregation requirement, did the common intention of the parties create a resulting trust? His Honour said:

While the express trust is a creature of the parties, the implied trust, be it resulting or constructive, is a creature of the law. The resulting trust is founded in the concept of common intent, that is to say, it

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<sup>8</sup> Barbara McDonald, 'Constructive Trusts' in Patrick Parkinson (ed) *The Principles of Equity* (1996) [2139]-[2142].

<sup>9</sup> Ibid [2143]; Jill E Martin, *Hanbury & Martin: Modern Equity* (15<sup>th</sup> ed, 1997) 267-268; *Cooke v Cooke* [1987] VR 625; *Hohol v Hohol* [1981] VR 221; *Higgins v Wingfield* [1987] VR 689; *Grant v Edwards* [1986] Ch 638; *Austin v Keele* (1987) 10 NSWLR 283; cf *Thwaites v Ryan* [1984] VR 65 (particularly the judgement of Fullagar J).

<sup>10</sup> GE Dal Pont and DRC Chalmers, *Equity and Trusts in Australia and New Zealand* (1996) 705-706.

<sup>11</sup> See the discussion in HAJ Ford and WA Lee, *Principles of the Law of Trusts* (3<sup>rd</sup> ed, 1996) [22340]; DWM Waters, *Law of Trusts in Canada* (2<sup>nd</sup> ed, 1984) 357-361.

<sup>12</sup> (1986) 59 CBR (NS) 79.

arises in cases where the court is satisfied by the words or conduct of the parties that it was their common intention that the beneficial interest in the property in question was not to reside in the party in possession, but rather was to be shared between them in some determined or determinable proportion.<sup>13</sup>

In rejecting a trust based on common intention, His Honour said:

That depends upon the existence of a perceived common intention to create a trust. While it may (or may not) have been in the mind of Paristyle from the execution of the lease that there did exist such mutuality of understanding necessary for the creation of a resulting trust, I interpret the document, in its operational clauses, to spell out a simple, straightforward business transaction. Paristyle is to make daily deposits with Holman's, to be credited to the Paristyle account. Over the course of the month various and varying debits are to be charged against the account. If at the end of the monthly accounting period there remains a credit balance showing on the ledger sheet, Holman's are to forward to Paristyle its cheque representing that credit balance. This exemplifies a common intention as to how the account is to be operated, which is not the same thing, in my view, as the common (*sic*) intention to create a trust. Accordingly, I find no resulting trust in the lease document.<sup>14</sup>

The case highlighted that a plaintiff seeking to prove that there was a trust was required to present convincing evidence of a common intention to have a trust regulate the relationship. The outcome was correct because the sub-tenants did take on the risk of the insolvency of the head tenant.

In *Ausintel Investments Australia Pty Ltd v Lam*,<sup>15</sup> a shareholder of a company called Ausintel Investments (Aust) Pty Ltd ('Austinel') Mrs Lam, had paid a deposit into a bank. This bank had provided charges to two other banks as security for liabilities of a company related to Austinel, Deutsche Anlagengeld Leasing Pty Ltd ('Deutsche'). The managing director of Ausintel had obtained agreement from Lam to convert the deposit from a security into equity capital by way of injection of deposit funds into Ausintel, in exchange for an allotment of shares. Thus, the company acquired funds to pay out the two security holding banks. The shares were

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<sup>13</sup> Ibid 84.

<sup>14</sup> Ibid 87-88.

<sup>15</sup> (1990) 19 NSWLR 637; See also *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669.



never issued and Lam sought the winding up of Ausintel. The company acknowledged its indebtedness and repaid an amount equivalent to the amount invested. However, the company refused to pay interest on those moneys. The New South Wales Court of Appeal held that the company did not owe interest to Lam. Meagher JA (with whom Gleeson CJ agreed) held that, in the absence of any express or implied agreement as to how the money was to be used, the investment funds became part of the assets of the company. The funds were not held on trust and there were no fiduciary obligations owed to Lam.<sup>16</sup> Mahoney JA said:

But, there are, in my opinion, a number of difficulties involved in this submission. First, the basis of the decision in *Barclays Bank Ltd v Quistclose Investments Ltd* itself appears to have been that the moneys paid to the company there in question was the subject of equitable obligations because it was the common intention of the parties that the beneficial ownership of the money should not pass from the payer to the company...In so far as that principle is relied on in this case, it is inapplicable because, if the legal transactions to be constructed were as I have stated them, then the ownership of the money was to pass to Ausintel because it in turn had to pass the ownership of the money to Deutsche which in turn was to pass it to the two banks. And the transactions were carried into effect as agreed.<sup>17</sup>

Even if the transactions had been subject to some kind of equitable obligation, that obligation had been discharged when Ausintel paid the money to Deutsche.<sup>18</sup> Again, the outcome was correct because there was no indication of any factors which would tend to undercut the normal function of money as a negotiable entity.

However, the case raises some interesting questions about how the Court would have approached the matter if Ausintel had refused to issue the shares and had become insolvent. Would Mrs Lam have been able to argue that she had acquired some proprietary interest by virtue of the agreement to issue the shares in the company and Ausintel's failure to disclose its imminent collapse? As there was no discernible common intention, it is strongly arguable that the answer would lie in an evaluation of the insolvent's conduct and the creditor's capacity to evaluate commercial risk in a fully informed way.

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<sup>16</sup> (1990) 19 NSWLR 637, 646-648.

<sup>17</sup> Ibid 641.

<sup>18</sup> Ibid 641-642.

### III THE MEANING OF UNCONSCIONABLE CONDUCT

Having highlighted the limitations of mutual intention, it is necessary to review the broad context in which equity may intervene without proof of intention or the existence of traditional equitable relationships.

It has been a basic contention of the thesis that equitable principle is the most appropriate basis for awarding proprietary relief. So, in order to ascertain whether equitable proprietary relief is available to an aggrieved party in an insolvency context, it is necessary to ascertain the appropriate equitable principles and apply them. It will be specifically contended that equity ought to intervene and provide proprietary relief when there is a causal connection between the insolvent's unconscionable conduct and the creditor's unsecured status. Therefore, it is necessary to understand the nature and scope of unconscionable conduct and the commercial environment in which the transaction takes place.

In Chapter 1, it was pointed out that there has been a reaction against equity intervening in commercial cases.<sup>19</sup> The concern has been that a judge will intervene on a subjective basis rather than on the basis of principle.<sup>20</sup> This concern is a legitimate one, in the light of the fact that some judges have suggested (perhaps unwittingly) that the concept of unconscionability or fairness is a broad one untrammelled by objective principle.<sup>21</sup>

So too, it is a legitimate contention that the law which governs commercial transactions and insolvency administration should be as certain and accessible as possible. For example, Lord Browne-Wilkinson said in *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* ('*Westdeutsche*')<sup>22</sup> that:

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<sup>19</sup> Chapter 1, 30.

<sup>20</sup> Peter Birks, 'Equity in the Modern Law: An Exercise in Taxonomy' [1996] 26 *The University of Western Australia Law Review* 1, 22-25.

<sup>21</sup> See for example Sir Robin Cooke, 'Fairness' [1989] 19 *Victoria University of Wellington Law Review* 421 and *Hussey v Palmer* [1972] 1 WLR 1286, 1289-1290 (Lord Denning); cf Parkinson, above n 1, [204].

<sup>22</sup> *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669.

a businessman who has entered into transactions relating to or dependent upon property rights could find that assets which apparently belong to one person in fact belong to another<sup>23</sup>

This remains a compelling reason why courts should limit the availability of proprietary relief. This approach would explain why Pincus J in *Re Miles; Ex parte National Australia Bank Ltd v The Official Receiver in Bankruptcy*<sup>24</sup> advocated a limitation of the device of mutual intention trusts<sup>25</sup> to loan situations found in *Barclays Bank Ltd v Quistclose Ltd*<sup>26</sup> and His Honour's statement in another case that:

One of the reasons why the process of liquidation or bankruptcy often produces such disappointing results is that the trustee or liquidator finds that litigation is necessary to recover property or resolve legal problems. Creditors tend to be reluctant to fund this. It appears to me that where the law is not quite settled, courts should lean in favour of results which conduce to certainty in bankruptcy administration.<sup>27</sup>

Indeed, another factor which must be noted in the quest for certainty, will be the need for trustees and liquidators to keep litigation costs to a minimum. It would be a complete travesty of justice if the assets which were the subject of dispute were devoured in the costs of litigation.

However, the need for certainty is tempered by the requirement that an insolvent should not unduly benefit from his unconscionable conduct. As insolvency regimes do not generally furnish clear rules in relation to unconscionable conduct, equitable principles remain relevant in insolvency administration.<sup>28</sup>

The concept of unconscionability (or unconscionable conduct) is at the core of the operation and intervention of equity throughout its history. Equity embraced a broad notion of fraud, which not only included actual fraud, but also the

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<sup>23</sup> Ibid 705.

<sup>24</sup> (1988) 20 FCR 194.

<sup>25</sup> Ibid 199.

<sup>26</sup> [1970] AC 567.

<sup>27</sup> *Re Osborn; Ex parte Trustee of Property of Osborn v Osborn* (1989) 91 ALR 135, 141.

<sup>28</sup> See *Ex parte James; Re Condon* (1874) LR 9 Ch App 609.

unscrupulous advantageous taking of the innate weakness of another person.<sup>29</sup> The concept of equitable fraud was an evolving one which would adapt to the exigencies of an era. Therefore, Lord Hardwicke said:

But as to relief against frauds, no invariable rules can be established. Fraud is infinite, and were a Court of Equity once to lay down rules, how far they would go, and no farther, in extending their relief against it, or to define strictly the species or evidence of it, the jurisdiction would be cramped, and perpetually eluded by new schemes, which the fertility of man's invention would contrive.<sup>30</sup>

And other judges have also called for the need to allow equity a degree of flexibility in dealing with fraud.<sup>31</sup> However, this flexibility has been reined in to prevent unconscionability being used as a blanket justification for an intuitive and subjective sense of justice.<sup>32</sup>

There have been recent and useful attempts to define the underlying rationale of equitable wrongdoing or unconscionable conduct; and by this means predict with some certainty the kinds of cases which will arise under this rubric.<sup>33</sup> What is stated below, is an attempt to refine these explanations and to connect the concept of unconscionable conduct with the way equity is operating in modern commercial transactions.

There are, broadly speaking, five kinds of conduct which fall within the general notion of unconscionable conduct. However, this is not a complete account because

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<sup>29</sup> *Earl of Chesterfield v Janssen* (1751) 2 Ves Sen 125, 155-156; 28 ER 82, 100.

<sup>30</sup> Letter to Lord Kames cited in LA Sheridan, *Fraud in Equity: A Study in English and Irish Law* (1957) 2.

<sup>31</sup> The Right Honourable Sir Raymond Evershed 'Influence of Remedies on Rights' (1953) 6 *Current Legal Problems* 1, 20 also cited in Sheridan, above n 30.

<sup>32</sup> See *Muschinski v Dodds* (1985) 160 CLR 583, 615 (Deane J).

<sup>33</sup> See for example, Paul Finn, 'Unconscionable Conduct' (1994) 8 *Journal of Contract Law*, 37; Parkinson, above n 1; David M Wright, *The Remedial Constructive Trust* (1998) [3.30].

it is impossible to describe definitively all the situations in which relief will be granted on the ground of unconscionable conduct.<sup>34</sup>

### ***A Common Law and Equitable Wrongdoing***

First, there are situations which both common law and equity will characterise as wrongdoing. In *Earl of Chesterfield v Janssen*,<sup>35</sup> Lord Hardwicke referred to actual fraud.<sup>36</sup> An important situation in insolvency contexts is theft of property. Here, not only may common law civil and criminal remedies be available, but equity may also provide relief as well. This situation is discussed further in Chapter 6.<sup>37</sup>

### ***B Breach of Equitable Obligations***

The second kind of conduct is breach of a pre-existing equitable obligation, such as a breach of trust,<sup>38</sup> breach of fiduciary obligations<sup>39</sup> or breach of confidence.<sup>40</sup> When there is a breach of these equitable duties, there is a fundamental violation of such trust and confidence. It is also possible that the notion of presumed undue influence may fall under this category. In some cases, it is assumed that a party reposes trust and confidence in another and that the transaction in issue has been effected by improper means.<sup>41</sup>

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<sup>34</sup> *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447, 461 (Mason J) quoted with approval in *Garcia v National Australia Bank Ltd* (1998) 155 ALR 614 [29] (Gaudron, McHugh, Gummow and Hayne JJ).

<sup>35</sup> (1751) 2 Ves Sen 125; 28 ER 82.

<sup>36</sup> *Ibid* 155; 100.

<sup>37</sup> Chapter 6, 225-226.

<sup>38</sup> Parkinson, above n 1, [208].

<sup>39</sup> *Ibid*. See also Chapter 2, 63-64.

<sup>40</sup> *Saltman Engineering Co Ltd v Campbell Engineering Co Ltd* (1948) 65 RPC 203; [1963] 3 All ER 413n. Megan Richardson and Jennifer Stuckey-Clarke, 'Breach of Confidence' in Patrick Parkinson (ed), *The Principles of Equity* (1996) 420, [1202].

<sup>41</sup> Parkinson, above n 1, [208]. See also *Garcia v National Australia Bank Ltd* (1998) 155 ALR 614 [33] (Gaudron, McHugh, Gummow and Hayne JJ).

## *C Exploitation of Vulnerability*

The third kind of equitable wrongdoing is where there is no pre-existing equitable obligation in the context of the commercial relationship, but a party can point to the exploitation of vulnerability or weakness, at the time that the transaction was entered into or when representations were made.<sup>42</sup>

One example of unconscionable dealing is where a party, aware of the vulnerability of the other, sets out to exploit it.<sup>43</sup> Such exploitation may also take the form of taking advantage of an apparent lack of business experience.<sup>44</sup> Another example is where there is conduct in which one party overbears the will of the other. This is the traditional rationale for undue influence.<sup>45</sup>

Unconscionable conduct may also be passive, but equally effective at the time of the transaction. It may well be that some forms of unconscionable dealing and undue influence are less actively unconscionable. This will be a matter of degree. However, equity will intervene when the conscience of the insolvent is tainted with the knowledge at the time of the transaction (or soon after), that the creditor has, for example, made a mistake or entered into an ultra vires transaction. Again, the foundation of the action in equity is the debtor's knowledge of his wrongdoing and the exploitation of the creditor's lack of information.<sup>46</sup>

In such cases, the exploitation of vulnerability (whether that vulnerability is conventional disadvantage, lack of business experience or simply a lack of information) is remedied by disclosure. The kind of disclosure which is required will depend on the case. However, such disclosure will inform the creditor of the prospective commercial risk and transforms it into an acceptable transaction from an equitable point of view.

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<sup>42</sup> *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447, 461 (Mason J).

<sup>43</sup> See for example *Wilton v Farnworth* (1948) 76 CLR 646; *Blomley v Ryan* (1954-56) 99 CLR 362.

<sup>44</sup> *A Schroeder Music Publishing Co Ltd v Macaulay* [1974] 1 WLR 1308; *Clifford Davis Management Ltd v WEA Records Ltd* [1975] 1 WLR 61; *Morlend Finance Corp (Vic) Pty Ltd v Luke* (1991) ASC ¶56-095.

<sup>45</sup> *Johnson v Buttress* (1936) 56 CLR 113, 134-135 (Dixon J); cf *Garcia v National Australia Bank Ltd* (1998) 155 ALR 614.

<sup>46</sup> See the discussion of Lord Browne-Wilkinson in *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669, 711-716.

## ***D Unconscionable Insistence on Rights***

A fourth kind of unconscionable conduct is where there is an unconscionable insistence on legal rights. For example, the law of equitable estoppel<sup>47</sup> and the law in relation to penalties and forfeiture<sup>48</sup> are based on this principle. In the recent decision of *Garcia v National Australia Bank Ltd*,<sup>49</sup> a majority of the High Court<sup>50</sup> drew on the existence of this recognised form of unconscionable conduct to explain in what situations equity would set aside a wife's guarantee of the husband's liabilities. They held that the lender was taken to understand that the wife may not fully understand the effect of the guarantee because she reposes trust and confidence in the advice of the husband. As a matter of principle, where the guarantee was voluntary (that is, the guarantor obtained no benefit from the transaction), the lender will be required to explain the transaction or be aware that the wife received competent, independent and disinterested advice.<sup>51</sup> Otherwise, the bank's enforcement of the guarantee and insistence on legal rights will constitute unconscionable conduct.<sup>52</sup>

## ***E Unconscionable Retention of Property***

Unconscionable conduct also encompasses situations in which, at the time of the transaction, an insolvent could not be accused of acting unconscionably. It is for this reason that Lord Browne-Wilkinson's judgment in *Westdeutsche*,<sup>53</sup> is unsatisfactory. It is possible for a party to act unconscionably after the initial transaction has been concluded and his conscience be sufficiently tainted to require equitable intervention. Here *Muschinski v Dodds* ('*Muschinski*') is relevant.<sup>54</sup>

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<sup>47</sup> *Central London Property Trust Ltd v High Trees House Ltd* [1947] KB 130; *Commonwealth v Verwayen* (1990) 170 CLR 394.

<sup>48</sup> *Legione v Hateley* (1983) 152 CLR 406; *Stern v McArthur* (1988) 165 CLR 489.

<sup>49</sup> *Garcia v National Australia Bank Ltd* (1998) 155 ALR 614.

<sup>50</sup> Gaudron, McHugh, Gummow and Hayne JJ.

<sup>51</sup> *Ibid* [31].

<sup>52</sup> *Ibid* [32].

<sup>53</sup> [1996] AC 669.

<sup>54</sup> *Muschinski v Dodds* (1985) 160 CLR 583.

A de facto couple bought a cottage as tenants in common in equal share in a domestic and commercial venture. A large portion of the purchase price was paid by the woman. It was agreed that the man would contribute his share of the purchase price by working in the commercial venture. The domestic relationship and commercial venture came to a premature end. The woman claimed that the man held the property on trust for her. The question was whether he did, and if so, on what basis?

Some important initial points need to be made. The woman could not argue that the parties had a common intention to create an express trust. The evidence indicated the opposite. The property was registered in the name of the two parties and it was the mutual intention of the parties that this would be the case. Therefore, it is not surprising, in the light of the woman's intention that the man benefit from the transaction, that arguments based on some kind of resulting trust were unsuccessful.<sup>55</sup> In this respect, the situation in *Muschinski* was similar to the transfer of funds where the intention of the transferor was that the transferee acquire the title of the money.

There was no suggestion that the man acted unconscionably prior to the transaction taking place. The case arose because the personal and commercial relationship came to an end. The understanding between the parties was that the man would acquire a registered legal interest in the property on the basis that in the future he would develop the property and build a kit house as the couple's residence. The man never performed these tasks. Therefore, equity was called upon to intervene in a case where there was a breakdown of a joint commercial and personal endeavour with no attributable blame.

Deane J, who handed down the leading judgement on unconscionable conduct in the case, made it clear that he did not want to expand equitable intervention to the extent that the concept of unconscionability would become a hollow justification for judicial intervention.<sup>56</sup> He carefully examined partnership cases from the last century where courts had to deal with the distribution of property, where there had been a dissolution of the partnership<sup>57</sup> and the parties had not set out

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<sup>55</sup> Ibid 590-593 (Gibbs CJ); 611-612 (Deane J).

<sup>56</sup> Ibid 615.

<sup>57</sup> Ibid 620; Note for example *Atwood v Maud* (1868) LR 3 Ch App 369.



how the property should be apportioned. For example, in *Lyon v Tweddell*<sup>58</sup> Jessell MR said that:

it is the duty of the Court when dissolving a partnership on equitable grounds to decide upon what fair terms the dissolution should be made. This has been treated in the argument as a simple question of return of part of the premiums. But that is only one element of the question. It is the duty of the Court to look at all the facts, and do what is equitable between the parties.<sup>59</sup>

In the light of these cases, Deane J opined that as a commercial relationship (and no more), the man's attempt to keep his interest in the property without compensating the woman, would have been unconscionable. The personal arrangements in this case did not alter this conclusion.<sup>60</sup> He stated in a crucial account of the principle of unconscionable conduct:

The prima facie rules respectively entitling a fixed term partner to a proportionate refund of his or her premium and a contractual joint venturer to a proportionate repayment of his or her capital contribution on the premature dissolution of the partnership or collapse of the joint venture are properly to be seen as instances of a more general principle of equity. That more general principle of equity can also be readily related to the general equitable notions which find expression in the common law count for money had and received...Like most of the traditional doctrines of equity, it operates upon legal entitlement to prevent a person from asserting or exercising a legal right in circumstances where the particular assertion or exercise of it would constitute unconscionable conduct...Those circumstances can be more precisely defined by saying that the principle operates in a case where the substratum of a joint relationship or endeavour is removed without attributable blame and where the benefit of money or other property contributed by one party on the basis and for the purposes of the relationship or endeavour would otherwise be enjoyed by the other party in circumstances in which it was not specifically intended or specially provided that that other party should so enjoy it. The content of the principle is that, in such a case, equity will not permit that other party to assert or retain

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<sup>58</sup> (1881) 17 Ch D 529.

<sup>59</sup> Ibid 531.

<sup>60</sup> (1985) 160 CLR 583, 621-622.

the benefit of the relevant property to the extent that it would be unconscionable for him to do.<sup>61</sup>

In this statement, Deane J made it very clear that equity's concept of unconscionable conduct encompassed far more than the kind of guilty conscience envisaged by Birks<sup>62</sup> or Lord Browne-Wilkinson.<sup>63</sup> The concept of unconscionability included situations where a party has acted initially with propriety, but the subsequent events turned out quite differently from original circumstances in which the property was transferred. Unconscionable conduct addressed the problem of the unconscionable retention of benefits on the breakdown of a joint endeavour. In *Muschinski* itself, Deane J held that a constructive trust in favour of the woman was appropriate. There was a joint or common endeavour which failed, due to the irreconcilable differences between the parties - but no one party could be blamed for the failure of the joint venture. However, if the man had retained the interest in the property, then he would have gained a benefit without performing the negotiated task. The man would have unconscionably retained the property.

It has been suggested that this broadened doctrine of unconscionability does not operate to restrain unconscionable conduct, but rather operates to avoid unjust outcomes.<sup>64</sup> However, it could be said that even this broadened notion of unconscionability is ultimately concerned with a party's unconscionable conduct. In *Muschinski*, the unconscionable conduct was the man's refusal to return his share of the property, notwithstanding the fact that he had not performed the agreed tasks.

It is significant that another illustration of unconscionable retention of property are the common money counts. Deane J showed that equity would be available to redress proprietary concerns in relation to quasi-contractual money had and received which makes up a substantial portion of the law of restitution.<sup>65</sup> Therefore, instead of contorting equitable mechanisms as recent restitution lawyers have done, the answer would be found in equity itself. The principle of

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<sup>61</sup> Ibid 619-620.

<sup>62</sup> Birks, above n 20, 71-72, 96.

<sup>63</sup> *Westdeutsche Girozentrale Landesbank v Islington London Borough Council* [1996] AC 669, 711-716.

<sup>64</sup> Parkinson, above n 1, [212].

<sup>65</sup> (1985) 160 CLR 583, 619.

unconscionable conduct would apply in the case of mistaken payment in *Chase Manhattan Bank NA v Israel-British Bank (London) Ltd.*<sup>66</sup> The ultimate recipient acquired a benefit in a situation where it would be unconscionable for the payee to retain the funds. The payer would be entitled to equitable proprietary relief without the need to contort the notions of fiduciary obligations.

Another example of unjust retention of property occurred in *Lord Napier and Ettrick v Hunter*.<sup>67</sup> Lord Templeman pointed out that it was unconscionable for an insured to retain payment under an insurance policy and damages from a wrongdoer.<sup>68</sup> The validity and integrity of the insurance contracts were not open to question. The problem was that the subsequent conduct of the insured was unconscionable because of the refusal to pay the settlement to the insurer which had honoured its obligations under the contract.

The broadened notion of unconscionable conduct also encompasses inequitable denial of obligations. These cases are not situations of common endeavour, like partnerships or commercial joint ventures. However, there is a transmission of property from one party to another on the basis that certain events will transpire. The kind of situations which may arise here is where property is conveyed to one party subject to an oral trust. A party who obtains the benefit of the property cannot then deny the existence of the trust, even though legal formalities have not been complied with.<sup>69</sup>

## ***F Commercial and Personal Relationships***

*Muschinski* concerned the dissolution of a personal relationship upon which commercial arrangements were engrafted. Paciocco suggests that courts ought to be more willing to provide proprietary relief in personal relationships rather than purely commercial ones.<sup>70</sup> As persons enter into marital and de facto relationships on the basis of affection and trust, they generally do not take action to protect their property

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<sup>66</sup> [1981] Ch 105.

<sup>67</sup> [1993] AC 713.

<sup>68</sup> Ibid 738.

<sup>69</sup> Parkinson, above n 1, [210].

<sup>70</sup> David M Paciocco, 'The Remedial Constructive Trust: A Principled Basis for Priorities Over Creditors' (1989) 68 *The Canadian Bar Review* 315, 325-328.

and legal relations in the same way as commercial parties. In comparison, commercial parties are aware that they should take steps to protect their interests. If they do not do so, they should not expect the assistance of the courts.

It is submitted that such a vastly different treatment of commercial parties on the one hand and domestic parties on the other is neither helpful or realistic. Equitable intervention and proprietary interests in assets should not depend simply on whether a relationship between two parties is characterised as commercial or domestic. A more subtle approach is needed, in the light of the fact that as the discussion in Chapters 2 and 3 has shown, equity has intervened in commercial relationships previously.

However, in the light of the legitimate concerns that equitable intervention should not renegotiate or re-write commercial transactions,<sup>71</sup> or create unnecessary uncertainty and be heavy handed,<sup>72</sup> such care is warranted. Therefore, the question is not whether proprietary relief will be available, but rather on what basis? This central issue will be the subject of further consideration.<sup>73</sup>

### ***G Unconscionable Conduct and Unjust Enrichment***

Another issue is whether the concept of unconscionable conduct considered in the broader context of *Muschinski*, is comparable to and interchangeable with the influential concept of unjust enrichment. Unjust enrichment has dominated United States, Canadian and New Zealand jurisprudence. In the United States, the remedial nature of the 'constructive' trust was recognised early. In the *Restatement of Restitution*<sup>74</sup> a constructive trust was said to arise '[w]here a person holding title to property is subjected to an equitable duty to convey it to another on the ground that he would be unjustly enriched if he were permitted to retain it.'<sup>75</sup> In *Restatement of*

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<sup>71</sup> See for example the views of Kirby P of the Supreme Court of New South Wales in *Austotel Pty Ltd v Franklins Selfserve Pty Ltd* (1989) 16 NSWLR 582, 585-586.

<sup>72</sup> *Woodson (Sales) Pty Ltd v Woodson (Aust) Pty Ltd* (1996) 7 BPR 14, 685, 14, 709 (Santow J).

<sup>73</sup> Below, Part IV and generally Chapter 6.

<sup>74</sup> American Law Institute, *Restatement of the Law of Restitution, Quasi Contract and Constructive Trusts* (1937).

<sup>75</sup> *Ibid* §160.

*the Law Second, Restitution, Tentative Draft No 2*<sup>76</sup> the constructive trust is described as 'a means of redressing unjust enrichment.'<sup>77</sup>

In Canada, unjust enrichment was developed as the criterion upon which *the* 'remedial' constructive trust was based. The monumental decision, *Pettkus v Becker* ('*Pettkus*')<sup>78</sup> entrenched the concept of unjust enrichment in Canadian law. *Pettkus* was, like *Allen v Snyder*, a dispute between a de facto couple about a property settlement. Instead of searching for the 'fugitive common intention',<sup>79</sup> a majority of the Canadian Supreme Court held that the concept of unjust enrichment applied. They said that:

there are three requirements to be satisfied before an unjust enrichment can be said to exist: an enrichment, a corresponding deprivation and absence of any juristic reason for the enrichment.<sup>80</sup>

The criteria has been applied in other Canadian cases.<sup>81</sup> In New Zealand,<sup>82</sup> a similar approach appears to be developing.

The concept of unjust enrichment used in the United States, Canada and New Zealand appears to have much in common with the concept of unconscionability identified in *Muschinski*, although this remains subject to considerable debate. It is arguable that the reason why some jurisdictions refer to unjust enrichment rather than unconscionability, is because of the early revival of quasi-contract and restitution in those jurisdictions. In the United States, the law of restitution was already part of the legal landscape in the first half of the 20th century. In 1954, restitution re-emerged in Canada as a significant underlying rationale for judicial intervention and the

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<sup>76</sup> American Law Institute, *Restatement of the Law Second, Restitution, Tentative Draft No 2* (1984).

<sup>77</sup> Ibid § 30b. Note also the discussion in Wright, above n 33, [2.18]-[2.22].

<sup>78</sup> [1980] 2 SCR 834; (1980) 117 DLR (3rd) 257. See also *Regional Municipality of Peel v Her Majesty the Queen in right of Canada* (1992) 98 DLR (4th) 140, 151-164 (McLachlin J).

<sup>79</sup> Ibid 842; 269 (Dickson J with whom Laskin CJC, Estey, McIntyre, Chouinard and Lamer JJ concurred).

<sup>80</sup> Ibid 848; 237-274 (Dickson J).

<sup>81</sup> See for example *Sorachan v Sorachan* [1986] 2 SCR 38; (1986) 29 DLR (4th) 1; *Peter v Beblow* [1993] 1 SCR 980; (1993) 101 DLR (4th) 621. Note in the context, Wright, above n 33, [2.23]-[2.30].

<sup>82</sup> See for example *Gillies v Keogh* [1989] 2 NZLR 327; *Lankow v Rose* [1995] NZLR 277. Note in this context Wright, above n 33, [2.32]-[2.40].

development of legal doctrine.<sup>83</sup> There are a number of proponents of the view that the concept of unjust enrichment is closely aligned to the equitable notions of unconscionable conduct. Toohey J of the High Court of Australia stated:

The notion of unjust enrichment...is as much at ease with the authorities and is capable of ready and certain application as is the notion of unconscionable conduct.<sup>84</sup>

In *Gillies v Keogh*,<sup>85</sup> Cooke P of the New Zealand Court of Appeal went so far as to subsume the notion of unjust enrichment and unconscionability under the rubric of reasonable expectations, when he said:

Whatever legal label or rubric cases in this field are placed under, reasonable expectations in the light of the conduct of the parties are at the heart of the matter. It can be said that a party is unjustly enriched if he or she retains the entire fruits of contributions made by the other, notwithstanding that the other has suffered detriment or made a sacrifice and has reasonably expected from the conduct of the first party and all the circumstances that the contributions will carry rights. Similarly, to retain the sole benefit can be labelled unconscionable or contrary to equity or manifestly unfair. Or the conduct of the first party may be said to give rise to an estoppel, proprietary or otherwise...<sup>86</sup>

However, this interpretation fails to address the fact that unjust enrichment and unconscionable conduct arguably respond to two very different events.<sup>87</sup> Unconscionability responds to equitable wrongdoing on the part of one party. In comparison, unjust enrichment responds to and remedies unjust outcomes in the light of the reasonable expectations of the parties. Nonetheless, it has been suggested that

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<sup>83</sup> *Degelman v Guaranty Trust Co of Canada and Constantineau* [1954] 3 DLR 785.

<sup>84</sup> *Baumgartner v Baumgartner* (1987) 164 CLR 137, 153. See also *Pavey & Matthews Pty Ltd v Paul* (1987) 162 CLR 221, 256-257 (Deane J) and The Honourable Sir Anthony Mason, 'The Place of Equity and Equitable Doctrines in the Contemporary Common Law World: An Australian Perspective' in Donovan WM Waters (ed), *Equity, Fiduciaries and Trusts 1993* (1993) 3, 14-18.

<sup>85</sup> [1989] 2 NZLR 327.

<sup>86</sup> *Ibid* 331. See also *Lankow v Rose* [1995] 1 NZLR 277, 293 (Tipping J); *Stratoulatos v Stratoulatos* [1988] 2 NZLR 424, 436-438 (McGeechen J); *Pasi v Kamana* [1986] 1 NZLR 603, 607 (Tompkins J).

<sup>87</sup> See for example *Bryson v Bryant* (1992) 29 NSWLR 188, 222-223 (Sheller JA).

neither unconscionable conduct nor unjust enrichment can be totally defined as simply responses to wrongdoing or unjust outcomes. As Waters has stated:

The two approaches have been compared. It has been said that unjust enrichment looks to the expectations of the parties, and enquires into the circumstances of one party's enrichment, while unconscionability directs attention to the conduct of that party, a person who has taken advantage. 'But that', comments the Chief Justice of Australia, 'is not to say that the expectations of the parties are irrelevant to the concept of unconscionable conduct.' Nor, of course, as one should add, is the defendant's conduct irrelevant to the decision of whether there has been an unjust enrichment. In *Pettkus v Becker* the Supreme Court of Canada spoke of the expectations of which during the time of the contributions the consequently enriched party, was, or ought to have been, aware. However, let it be said that the embrace of a conduct assessment may indeed be wider than that of an enrichment (or outcome) assessment.<sup>88</sup>

Certainly, two factors would support Waters' contention that there is, at the very least, a considerable overlap of the concept of unconscionability and unjust enrichment. First, unconscionable conduct of the *Muschinski* variety could be considered as being outcome driven, as well as directed to unconscionable retention of property.<sup>89</sup> After all, Deane J did stress that the concept of unconscionable conduct in equity could be directed to an evaluation of a situation where neither of the parties was blameworthy - the breakdown of the commercial venture was one of those events which occurs in human relationships. Secondly, the important word in the phrase 'unjust enrichment' is the word 'unjust.' Not all enrichments are unjust in commercial transactions. Therefore, if an enrichment is unjust in accordance with the definition in *Pettkus* referred to above, it is likely that the conduct of the insolvent (whether of an active or passive kind) may be relevant to the situation. The conduct of the insolvent at the time the transaction was entered into may not have offended commercial sensibilities, but the attitude of the insolvent is subsequently unconscionable. At any rate, the debate remains an arid one without the realisation that whether unconscionable conduct or unjust enrichment is argued as the basis of the proprietary interest or relief, a party is seeking equitable proprietary relief. Thus, generally, an examination of the insolvent's conduct will be relevant from an

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<sup>88</sup> Donovan WM Waters, 'The Nature of the Remedial Constructive Trust' in Peter Birks (ed), *The Frontiers of Liability* (1994) vol 2, 163, 170; cf JW Carter, 'Restitution and Contract Risk' in Mitchell McInnes (ed), *Restitution: Developments in Unjust Enrichment* (1996) 137, 161.

<sup>89</sup> Parkinson, above n 1, [204] and [212].

equitable point of view, even if it is not the only relevant factor underpinning a determination of whether equitable proprietary relief ought to be available. In *Muschinski*, the man's conduct was unconscionable because he sought to retain a benefit to which he was not entitled. It is likely that if the case had arisen in Canada rather than Australia, the Canadian courts would have labelled his acquisition of the benefit as an unjust enrichment. Ultimately, it is contended, the concept of unconscionable conduct is so broadly drawn in *Muschinski* to comprise most (if not all) cases which would be amenable to an analysis based on unjust enrichment.

The concept of unjust enrichment has been utilised in not only personal relationships, but also in commercial cases as well. In the United States, it appears that unjust enrichment in the context of constructive trusts has been utilised in a wide array of commercial cases.<sup>90</sup> In contrast, in Canada, the concept of unjust enrichment as the source of equitable proprietary relief has been particularly important in personal or family contexts.<sup>91</sup> Thus, the question has been to what extent the learning in the family cases is applicable to commercial cases.<sup>92</sup> There is a body of case law which shows that the concept of unjust enrichment will be available to sustain equitable proprietary relief in commercial situations which lie outside areas where traditional proprietary relief has been available.<sup>93</sup>

In recent times, the concept of unjust enrichment has also re-emerged in England.<sup>94</sup> However, it is unclear what future proprietary course proprietary relief for unjust enrichment will take.

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<sup>90</sup> See the various cases described in American Law Institute, *Restatement of the Law of Restitution, Quasi Contracts and Constructive Trusts*, (1988), vol 3 Appendix, § 160, 140-206.

<sup>91</sup> For a critique of such cases see Patrick Parkinson, 'Beyond *Pettkus v Becker*: Quantifying Relief for Unjust Enrichment' (1993) 43 *University of Toronto Law Journal* 217.

<sup>92</sup> Paciocco, above n 70, 325; Waters, above n 88, 171-172.

<sup>93</sup> Waters, above n 88, 172; *Atlas Cabinets and Furniture v National Trust Company Ltd* (1988) 24 BCLR (2d) 389; (Taylor J); 45 BCLR (2d) 99 (CA); *Phoenix Assurance Co of Canada v Corporation of the City of Toronto* (1982) 129 DLR (3d) 351; (1982) 35 OR (2d) 16; 142 DLR (3d) 767; 39 OR (2d) 680; *Hunter Engineering Inc (Hunter Machinery Canada Ltd), Integrated Metal Systems Canada Ltd and Allis-Chalmers Canada Ltd v Syncrude Canada Ltd* [1989] 1 SCR 426; 35 BCLR (2d) 145.

<sup>94</sup> *Lipkin Gorman (A Firm) v Karpnale Ltd* [1991] 2 AC 548; Peter Birks, 'The English Recognition of Unjust Enrichment' [1991] *Lloyds Maritime and Commercial Law Quarterly* 473.



Here, it is appropriate to distinguish between the concept of unjust enrichment discussed above and the concept of unjust enrichment described by Birks. For Birks, the concept of unjust enrichment is essentially a common law concept, which is quite apart from unconscionable conduct. Birks criticises the concept of unconscionability as being too narrow and vague to determine whether a proprietary remedy should be imposed.<sup>95</sup> Criticising *Westdeutsche*, Birks has stated:

The law of trusts, working in different language and organising its thought in categories of response rather than categories of event, has failed to understand that strategy and, even when in fact responding to unjust enrichment, has stuck to the old habit of restricting the cause of the cause of action, using, as its chosen restrictor, the guilty conscience. Only the guilty will answer. We cannot accommodate two strategies.<sup>96</sup>

The kinds of 'events' which Birks had in mind are mistaken payments and ultra vires transactions (which occurred in *Westdeutsche* itself). However, the statement contained certain flawed assumptions.

Birks has assumed that the availability of equitable proprietary remedies is limited to cases where a court exercising equitable jurisdiction can be convinced that the actions of an insolvent are the result of the insolvent's wrongdoing or 'guilty conscience' prior to, or at the time of, the receipt of funds.<sup>97</sup> Whilst Birks has been critical of the reasoning and outcome of the *Westdeutsche* case,<sup>98</sup> the attitude of both Birks and Lord Browne-Wilkinson in *Westdeutsche* is similar in one fundamental aspect. Both confine equity to a peculiarly narrow function - an arbiter of the conscience of the insolvent upon receipt of the funds. However, the difference between their two positions should also be highlighted. Lord Browne-Wilkinson correctly held that equitable jurisdiction will be called into play in deciding whether a plaintiff is entitled to a proprietary remedy. In contrast, Birks does not see a role for

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<sup>95</sup> Birks, above n 20, 16-25, 67-69; cf Joshua Getzler, 'Unconscionable Conduct and Unjust Enrichment as Grounds for Judicial Intervention' (1990) 16 *Monash University Law Review* 283; Steve Hedley, 'Unjust Enrichment as the Basis of Restitution - An Overworked Concept' (1985) 5 *Legal Studies* 56; Steve Hedley, 'Restitution' (1995) *Cambridge Law Journal* 578; John Glover, 'Equity and Restitution' in Patrick Parkinson (ed) *The Principles of Equity* (1996) 92.

<sup>96</sup> Ibid 96.

<sup>97</sup> Cf the views of Paciocco, above n 70, 347-348.

<sup>98</sup> [1996] AC 669.

equity. However, as discussed, there is ample case law which suggests that equitable unconscionability encompasses a wide array of conduct. As the concept of unconscionability in equity covers much of the law of restitution, it can be said that Birks' notion of unjust enrichment is consistent with equity's concept of unconscionable conduct (although he would no doubt, argue otherwise).

Birks has also identified a role for the common law's proprietary potential.<sup>99</sup> Apparently, the common law should be able to provide relief without the intervention of equity and the occasions where unjust enrichment will accord such relief will be small. He has stated in relation to ownership and security of receipts:

The interest in obtaining restitution of unjust enrichment comes into conflict with the interest in the security of receipts. Honest and reasonable people ought to be able to dispose as they please such wealth as appears to be at their disposition. If claims in unjust enrichment proliferated uncontrolled everyone would have to set a contingency fund or take out special insurance against the possibility of unsuspected restitutionary liability. One way of giving effect to the interest in security of receipts is to make claims in unjust enrichment very difficult to bring - for example, by cutting down the kinds of mistake which will trigger restitution (no restitution for mistakes of law, and none for mistakes of fact unless the mistake gives the impression of legal liability to pay) or by insisting that a failure of consideration counts for nothing unless the failure be total. Another version of the same strategy is to insist that the defendant cannot be liable unless he has been at fault...equity appears to have settled intuitively on that approach but, partly no doubt because the process has been merely intuitive, it has not been wholly consistent in doing so.<sup>100</sup>

And, in a discussion entitled 'Unjust enrichment trusts' he has stated:

We noticed earlier that the law of unjust enrichment has adopted a particular strategy for reconciling the interest in restitution with the interest in the security of receipts. That strategy, primarily mediated by the defence of change of position, can be summed up by saying that inessential restrictions which formerly protected the interest in security of receipts, albeit insensitively, have been removed from the cause of action in unjust enrichment but that claims arising from that cause of action have been made more fragile, to ensure that honest

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<sup>99</sup> See the discussion of following and tracing in Birks, above n 20, 85-89.

<sup>100</sup> Ibid 68.

and reasonable recipients can safely rely on the security of their receipts.<sup>101</sup>

Therefore, if there is a claim based on unjust enrichment, the claimant should be entitled to both personal and proprietary remedies. There will be greater certainty in the award of the proprietary relief because unlike equity, unjust enrichment is event based.<sup>102</sup> There were several means by which he suggested that remedies for unjust enrichment may not be available. First, if the defendant can claim a defence of change of position. Secondly, he suggested that perhaps the scope for action for unjust enrichment may be able to be narrowed by streamlining the events to which it will apply. Thirdly, he suggested that only honest and reasonable people should be able to retain the security of receipts. If a claimant is not honest and/or is unreasonable, he or she will not have security in the receipt.

The problem here is that he quarantined the law of restitution from equity (other than in the use of an equitable remedy of the trust), relied on the uncertain defence of change of position and potentially straightjacketed the kinds of situations where a claimant will be able to claim proprietary relief. The defence of change of position is noted below<sup>103</sup> and it is sufficient to point out that the form which this defence will take remains to be fully sketched by judges.<sup>104</sup> Moreover, the setting of pre-determined events which will give rise to proprietary relief is unhelpful, because it is impossible to predict with any confidence a complete set of circumstances in which the need for proprietary relief may arise.

If honesty and reasonableness are important in the context of claims in restitution, then it should be pointed out that equity also has placed great store on these characteristics, as well as in the development of the concept of unconscionable conduct. And, whilst equity may not be event based in quite the same way as Birks posits restitution is event based, there are discernible trends in the way equity has applied the concept of unconscionability to factual situations.

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<sup>101</sup> Ibid 96.

<sup>102</sup> Ibid 66-69.

<sup>103</sup> Chapter 6, 340-342.

<sup>104</sup> Note *Lipkin Gorman (A Firm) v Karpnale Ltd* [1991] 2 AC 548, 577-583 (Lord Goff); *David Securities Pty Ltd v Commonwealth Bank of Australia* (1992) 175 CLR 353, 384-386 (Mason CJ, Deane, Toohey, Gaudron and McHugh JJ); Andrew Burrows *The Law of Restitution* (1993) 424.

## **H Review**

So far, it has been argued that the concept of equitable wrongdoing extends well beyond breach of trust or fiduciary obligations or the unscrupulous taking advantage of the vulnerability of commercial parties. Obtaining a benefit without undertaking the negotiated task, as in *Muschinski*, will also give rise to equitable intervention. Whether this situation is labelled as unconscionable conduct or unjust enrichment is ultimately unhelpful where a party seeks to argue another party has acquired an equitable proprietary interest by virtue of this unconscionable conduct or unjust enrichment. Such a characterisation does not answer the question whether the aggrieved party will be entitled, in a particular case, to an equitable proprietary interest by virtue of the conduct or the enrichment. As one author has perceptively noted, in relation to the concepts of unconscionable conduct and unjust enrichment:

Confusion only arises, however, if either of them are elevated into self-standing legal principles which may be applied without more precise doctrinal analysis. As explanations for the rationale which underlies a variety of specific doctrines, both are useful. However, they are stated at too great a level of abstraction to be helpful as doctrinal formulae in their own right.<sup>105</sup>

Therefore, having identified the breadth of equity's jurisdiction, it is necessary to consider the modern underpinnings of this jurisdiction and in so doing, move towards the creation of an inherently coherent and logical scheme for equitable proprietary relief.

## **IV A THEORY OF OBJECTIVE NON-ASSUMPTION OF RISK**

### ***A Introduction***

Judges, insolvency administrators and commercial parties should be mindful of important assumptions and significant requirements of the world of commerce. These matters were considered in Chapter 1. The overwhelming assumption is that risk taking is part of a commercial world which is characterised by 'self-interest and profit-making.'<sup>106</sup> In addition, where the transfer and receipt of money is concerned,

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<sup>105</sup> Parkinson, above n 1, [212].

<sup>106</sup> *Austotel Pty Ltd v Franklins Selfserve Pty Ltd* (1989) 16 NSWLR 582, 586 (Kirby P).

money is negotiable and title to that money resides with the recipient. Quite legitimately, commercial parties require a degree of legal certainty so that they may play the commercial game in accordance with established and well recognised parameters.<sup>107</sup> Without such fundamental operative principles, the world of commerce would simply grind to a halt. People would not invest in commercially attractive ventures. Money would not function as an essentially negotiable commodity. Commercial traders would be averse to entering transactions where there was little certainty as to what was the legal characterisation of the relationship and the rights and duties associated with that relationship.<sup>108</sup>

One of the fundamental norms in relation to risk taking has been that a party will be an unsecured creditor, unless he avails himself of a security device to protect his position in the event that the other commercial party becomes insolvent. This important norm was fortified, in a series of real estate agency cases, in which courts in Canada have made it clear that, *prima facie*, real estate agents were mere unsecured creditors for their commission.<sup>109</sup> So too, in *Walker v Corboy*<sup>110</sup> the Court decided that there was nothing on the facts of the case which indicated that the way that the particular principal and agency relationship operated deviated from the characterisation of the relationship as essentially an unsecured debtor and creditor relationship.

### ***B A Theory of Objective Non-Assumption of Risk***

However, notwithstanding the *prima facie* assumption that commercial parties bear all risks associated with a transaction, courts have intervened and provided proprietary relief. Therefore, courts have overturned commercial norms in

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<sup>107</sup> See *Lankshear v ANZ Banking Group (New Zealand) Ltd* [1991] 1 NZLR 481, 495-496 (Wallace J); *Barnes v Addy* (1874) LR 9 Ch App 244, 251 (Lord Selborne); *Scandinavian Trading Tanker Co AB v Flota Petrolera Ecuatoriana* [1983] 2 AC 694, 703-704 (Lord Diplock); *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669, 704-705 (Lord Browne-Wilkinson).

<sup>108</sup> As to the need for commercial certainty see Chapter 1, 17-20.

<sup>109</sup> *Re Allan Realty of Guelph Ltd* (1980) 97 DLR (3d) 95; (1979) 24 OR (2d) 21; *Re Ridout Real Estate Ltd* (1958) 36 CBR 111; *Price Waterhouse v Vic MacLeod Real Estate Ltd* (1983) 48 CBR (NS) 191; *Re century 21 Brenmore Real Estate Ltd* (1979) 24 OR (2d) 783; (1979) 30 CBR (NS) 71.

<sup>110</sup> (1990) 19 NSWLR 382.

some situations. Unfortunately, in so doing, courts have not articulated what they were doing.

It is submitted that central to any determination about the award of proprietary relief in commercial transaction is the issue of risk assumption. More specifically, in the case of proprietary relief, did the unsecured creditor assume the risks associated with being unsecured in the event of the other party's insolvency? If the circumstances indicated that he did so, proprietary relief would not be available. However, if the relationship of the parties and the factual circumstances indicated that he could not have taken protective action, then proprietary relief may be appropriate. Here, the focus of equity, which is concerned with redressing unconscionable conduct, must be directed not only to the conduct of the creditor but also the conduct of the insolvent as well. The issue is whether the insolvent acted unconscionably. As equity has broadly defined unconscionable conduct, there could be a number of aspects of the insolvent's conduct which could become a subject for scrutiny. If the insolvent had not acted unconscionably towards the creditor, then it is unlikely that the creditor would obtain proprietary relief. However, if the insolvent acted unconscionably, then the issue which will arise is whether the unconscionable conduct caused or led to the unsecured status of the creditor. The court will need to consider whether there was a causal connection between the creditor's unsecured status and the insolvent's unconscionable conduct.

Therefore, when addressing modern concerns about whether a court should provide proprietary relief, it must be appreciated that equity's concern about remedying unconscionable conduct is inextricably linked to risk assumption. An evaluation of many areas of traditional proprietary relief discussed in Chapter 2 indicated that proprietary relief was awarded because the unconscionable conduct of the insolvent caused the unsecured status of the creditor. For example, a party who is owed fiduciary obligations does not generally take steps to minimise the risks associated with its relationship with the fiduciary and is not expected to do so. If the fiduciary acts unconscionably and then becomes insolvent, equity will intervene and provide proprietary relief.<sup>111</sup> This is what occurred in the development of the institutional constructive trust, equitable tracing and the rule in *Barnes v Addy*.<sup>112</sup> In some cases, the nature of the fiduciary relationship, such as in the case of agents and brokers, does not predispose courts to provide automatic proprietary relief. However,

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<sup>111</sup> Chapter 2, 45-46, 63-66, 72-74.

<sup>112</sup> (1874) LR 9 Ch App 244.

they will do so where the wrongdoing of the broker or the agent is causally linked to the unsecured status of the party to whom fiduciary obligations are owed. For example, in *Australian Securities Commission v Melbourne Asset Management Nominees Pty Ltd (Receivers and Managers Appointed)*,<sup>113</sup> the failure of MAM to invest the funds as prescribed was unconscionable conduct which led to the unsecured status of the investors. Another situation where equitable proprietary relief arose in response to unconscionable conduct was in the seminal case *Lord Napier and Ettrick v Hunter*,<sup>114</sup> where insurers acquired an equitable proprietary interest in the proceeds of damages paid to the insured (because the insured refused to pay these moneys to them). A similar approach is applicable to situations which stand outside traditional equitable relationships. The issue is whether, from an objective standpoint, the creditor did not, and could not be expected to, assume the risk associated with an unsecured status. A theory of objective non-assumption of risk could be articulated in the following way:

(i) the insolvent in fact acquired a benefit (in this case, money) at the commencement or during the course of the commercial relationship between the parties;

(ii) the creditor did not in fact take steps (or adequate steps) to minimise risk in the commercial transaction (and in particular the potential risk of the insolvency and the creditor's unsecured status);

(iii) objectively speaking, the creditor could not be expected to minimise the risks associated with the commercial transaction in the light of the commercial milieu in which the commercial transaction took place; and

(iv) objectively speaking, the creditor could not be expected to minimise the risk of the commercial transaction because the unconscionable conduct (broadly defined) of the insolvent directly contributed to the unsecured status of the creditor. Another way of stating this is that the insolvent obtained or retained the benefit via some form of unconscionable conduct.

Items (i) and (ii) highlight that the insolvent acquired funds by way of transfer or collection. The money operated as a negotiable entity and so title has

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<sup>113</sup> (1994) 49 FCR 334.

<sup>114</sup> [1993] AC 713.

passed to the insolvent. The creditor is a mere unsecured creditor who has not taken adequate action to elevate himself above the status of an unsecured creditor.

Items (iii) and (iv) locate the two factors which determine whether a creditor has, objectively speaking, assumed or not assumed the commercial risk of a transaction (including, of course, the potential insolvency of the other party and the unsecured status). Item (iii) requires that there was not an assumption of the risks associated with an unsecured creditor. Item (iii) makes it clear that an objective evaluation of the commercial environment and normal business practices will be required. For example, in *Muschinski*,<sup>115</sup> the woman was entitled to equitable intervention in the personal and commercial relationship. The woman had not taken steps to deal with the premature breakdown of the joint venture. However, the woman could not be expected to have taken steps to alleviate the risk of the transaction. Partners in close personal relationships do not usually act to minimise the impact of the breakdown of the relationship, do not clearly define their rights in advance or may be unable to do so.<sup>116</sup> Such conduct operates against the personal commitment, trust and confidence between the parties. In comparison, in *Walker v Corboy*,<sup>117</sup> the farmers had not taken any action in addition to the statutory regulation to protect themselves against the risks associated with an agency relationship and their unsecured status. If the farmers had wished to protect themselves against risk, they ought to have done so in the light of the prevailing commercial norms. There was nothing in the relationships between the farmers and the agent which indicated that the farmers had not assumed the risk. This contrasts with a subjective approach, where a creditor argues that subjectively speaking, he did not assume the risks of an unsecured creditor. From the point of view of determining, whether proprietary relief ought to be available, this would not be a satisfactory standard. Any unsecured creditor would try and argue that he had not assumed the risks of being an unsecured creditor in the hope of achieving, effectively, a secured status. The net effect of such an approach would be that all unsecured creditors would claim non assumption of risk with the effect that interests of secured creditors would be undermined.

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<sup>115</sup> [1985] 160 CLR 583.

<sup>116</sup> *Fender v St John Mildway* [1938] AC 1. Note also *Family Law Act 1975* (Cth) s 79 and *In the Marriage of JD and AM Hannema* (1981) 7 Fam LR 542.

<sup>117</sup> (1990) 19 NSWLR 382.



Item (iv) draws on the pre-existing case law concerning the nexus between unconscionable conduct and proprietary relief. In *Muschinski*,<sup>118</sup> the man's refusal to recognise that his interest in the property was predicated on the completion of certain tasks, and the failure to act on that basis amounted to unconscionable conduct. The proprietary relief awarded was directly linked to the fact that the man had acted unconscionably. In comparison, in *Walker v Corboy*,<sup>119</sup> there was no suggestion that the agent had acted unconscionably. Therefore, the farmers' unsecured status was not attributable to the agent's unconscionable conduct. There was nothing which 'brought a non-express trust...or equitable obligation into existence.'<sup>120</sup>

The material in items (iii) and (iv) have been drafted separately to highlight the importance of the commercial context and unconscionable conduct. However, those items are not mutually exclusive. The unconscionable conduct of the insolvent may explain why the creditor was unable to minimise the risk of the commercial transaction, notwithstanding market practice. The insolvent's unconscionable conduct was so overwhelming that it prevented the creditor from following commercial risk minimisation strategies. Therefore, in relation to some cases, the unconscionable conduct identified in item (iv) would have a direct effect on a determination in item (iii).

It could be argued that an equitable emphasis on an objective examination of the commercial milieu, unconscionable conduct and the assumption of risk, sets the concept of unconscionable conduct apart from unjust enrichment. In *Banque Financière de la Cité v Parc (Battersea) Ltd*,<sup>121</sup> the House of Lords held that the application of subrogation as a response to unjust enrichment was not barred because the creditor had not sought securities<sup>122</sup> or identified fault on the part of the insolvent.<sup>123</sup> However, it will be argued in Chapter 6 that the House of Lords was in error in its characterisation of the commercial relationship and the appropriate cause of action. The facts in the case indicated that the creditor had sought and obtained a

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<sup>118</sup> [1985] 160 CLR 583.

<sup>119</sup> (1990) 19 NSWLR 382.

<sup>120</sup> Ibid 385 (Priestley J).

<sup>121</sup> [1998] 2 WLR 475.

<sup>122</sup> Ibid 481, 486-488 (Lord Hoffman).

<sup>123</sup> Ibid 479 (Lord Steyn); 494 (Lord Hutton).

form of security. Objective non-assumption of risk could have informed the outcome of the case.

There are sound reasons why proprietary relief ought to be available to redress unconscionable conduct causally linked to a creditor's unsecured status. Without the availability of the equitable proprietary relief in such cases, equity will become a blunt tool where an equitable wrongdoer is insolvent. The solvency or insolvency of the equitable wrongdoer would determine whether a creditor was effectively successful, rather than the fact of wrongdoing. In the long term, the wrongdoer and its creditors would benefit from the unconscionable conduct.

Moreover, a recognition that proprietary relief would be available in the circumstances described will create a degree of certainty. Therefore, instead of investigating whether the insolvent's conduct was unconscionable and then diverging into a speculation whether proprietary relief was appropriate, the focus of the determination would be whether the insolvent's conduct was unconscionable and whether that conduct caused the creditor's unsecured status.

There are only three 'exceptions' to the provision of equitable proprietary relief to redress such unconscionable conduct. The first exception has already been highlighted above, namely where (notwithstanding the unconscionable conduct of the insolvent) the creditor was expected to take steps to minimise commercial risks. This exception is part of the theory of objective non-assumption of risk. This issue is discussed further in Chapter 6. This requirement will limit the situations where equitable proprietary relief is available in commercial transactions to those where the insolvent's unconscionable conduct was causally linked to the creditor's unsecured status. Therefore, it will operate to differentiate those cases where only a personal remedy should be available as a response to unconscionable conduct. For example, a large corporate lender may be able to obtain a personal remedy when it has lent money under an unsecured ultra vires contract. However, in the light of its failure to take action to minimise risk, a proprietary remedy should not be available.

The second and third exceptions are true exceptions to objective non-assumption of risk. The second is where objective non-assumption of risk is established, but there are no available assets from which the creditor can secure proprietary relief. There may be no asset base, or alternatively, all assets are subject to pre-existing securities. This issue is further discussed in Chapter 7.

The third exception is where objective non-assumption of risk is established, but the insolvent raises a successful defence against the intervention of equity. This is discussed in Chapter 7.

## V CONCLUSION

In this Chapter, it was argued that the award of equitable proprietary relief, particularly in the context of insolvency, is governed by equitable notions of unconscionable conduct. Attempts to sever equitable relief from the doctrinal basis of equitable intervention, unconscionable conduct, produces unnecessary confusion and uncertainty.

It was then argued that equitable proprietary intervention could be broadly explained on the basis of the linking of unconscionable conduct and the non-assumption of risk. Proprietary relief ought to be available where the unconscionable conduct is causally connected to the unsecured status of the creditor. This was described as the theory of objective non-assumption of risk. The objective non-assumption of risk explains traditional as well as newer categories of equitable proprietary intervention. Once an objective non-assumption of risk is established, a creditor would be entitled to proprietary relief, subject to the exceptions noted.

In the following chapter, a non-exhaustive application of the objective non-assumption of risk is undertaken.

## **Chapter 6**

### **EQUITY'S DOMAIN: THE APPLICATION OF THE THEORY OF OBJECTIVE NON-ASSUMPTION OF RISK**

## I INTRODUCTION

This chapter is concerned with the practical application of the objective non-assumption of risk theory. For the purposes of the discussion, two assumptions are made. First, it will be assumed that one party in the commercial transaction has in fact acquired a benefit, namely money, by virtue of a commercial relationship. The only situation discussed below which falls outside such cases is theft of property. The second assumption is that the aggrieved party did not take adequate steps to minimise the risks inherent in the commercial transaction (including the potential insolvency of the recipient).

The criteria which is subject to scrutiny in this chapter are items (iii) and (iv) as outlined in Chapter 5. Item (iii) refers to the commercial expectations of parties and the central importance of the commercial milieu and market practice in which the transaction took place. Item (iv) encapsulates the view that the conduct of the defendant should be subject to scrutiny. Such conduct must be unconscionable, albeit broadly defined.<sup>1</sup> Items (iii) and (iv) are not mutually exclusive. Therefore, the unconscionable conduct of the insolvent may affect the creditor's capacity to minimise risk notwithstanding market practice.

The following discussion will consider a number of situations where there has been unconscionable conduct on the part of the defendant; and where equity has or ought to provide equitable proprietary relief. However, in the light of the constantly changing ways in which commercial relationships are carried out, the discussion is not and cannot pretend to be an exhaustive illustration of the theory. However, it is hoped to show that equity is not overly interventionist and that such intervention can be undertaken on a rational and coherent basis.

## II MARKET CONTEXT AND THE CREDITOR'S CONDUCT

The first step towards determining whether proprietary relief is warranted is a careful examination of 'the commercial milieu in which the particular dispute has arisen.'<sup>2</sup> A helpful aspect of the 19th century's emphasis on laissez-faire

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<sup>1</sup> *Earl of Chesterfield v Janssen* (1751) 2 Ves Sen 125, 155-157; 28 ER 82, 100-101 (Lord Hardwicke); *Muschinski v Dodds* (1985) 160 CLR 583, 616-623 (Deane J).

<sup>2</sup> (1990) 19 NSWLR 382, 386 (Priestley J).

individualism was that it located the necessity for commercial self reliance. Commercial parties cannot expect courts to intervene in every transaction which goes awry. Therefore, the question will be whether the creditor could be expected, in the light of the particular market, to exercise commercial self reliance.

In order to decide whether the creditor could, or could not, be expected to take on the risk of an unsecured creditor, it will be necessary for the creditor to establish the market practice. It will form a practical background to explain why a creditor was not expected to minimise commercial risk. The market context will also be important to establish how a creditor would be expected to minimise such risk, but was prevented from doing so by the insolvent's unconscionable conduct. There are many different kinds of commercial transactions which have been the subject of consideration and discussion in previous chapters including banking transfers,<sup>3</sup> deposits,<sup>4</sup> loans,<sup>5</sup> broking transactions,<sup>6</sup> agency transactions<sup>7</sup> and swap arrangements.<sup>8</sup> Each kind of transaction has its own internal dynamics and various burdens on the creditor to protect their commercial position. A contrast of very different commercial transactions will make this proposition clearer.

Different commercial standards regulate the lending by and the deposit of money in a financial institution. When considering the lending of money to potential customers, banks generally take a reasonably cautious approach.<sup>9</sup> Thus, financial institutions will generally undertake a series of investigations about the potential

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<sup>3</sup> *Chase Manhattan Bank NA v Israel-British (London) Ltd* [1981] Ch 105.

<sup>4</sup> *Great Atlantic & Pacific Tea Co v Citizens' National Bank* 2 F Supp 29 (District Court Pennsylvania, 1932).

<sup>5</sup> *Barclays Bank Ltd v Quistclose Investments Ltd* [1970] AC 567; *General Communications Ltd v Development Finance Corporation of New Zealand Ltd* [1990] 3 NZLR 406; *Daly v Sydney Stock Exchange Ltd* (1986) 160 CLR 371.

<sup>6</sup> *Re Goode; Ex parte Mount* (1974) 4 ALR 579; 24 FLR 61; *Meth v Commercial Banking Company of Sydney Ltd* (1977) ACLC ¶40-302.

<sup>7</sup> *Walker v Corboy* (1990) 19 NSWLR 382; *Stephens Travel Service International Pty Ltd (Receivers and Managers Appointed) v Qantas Airways Ltd* (1988) 13 NSWLR 331; *Air Canada v M & L Travel Ltd* [1993] 3 SCR 787.

<sup>8</sup> *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 699.

<sup>9</sup> PJM Fidler, *Sheldon and Fidler's Practice and Law of Banking* (11<sup>th</sup> ed, 1982) 269.

borrower including the borrower's legal capacity to borrow,<sup>10</sup> the creditworthiness of the borrower,<sup>11</sup> the purpose of the loan,<sup>12</sup> the source of repayment the duration of the risk and whether security is available.<sup>13</sup>

In contrast, simple depositors of funds in financial institutions are not required to undertake an investigation of the capacity of the institution to attract funds, the creditworthiness of the financial institution and the source of the repayment of the deposited fund, which is essentially a debt. The case law discussed in Chapter 4 indicated that during the Depression, depositors were entitled to assume creditworthiness when the institution was still operating and there had been no disclosure of any financial crisis. Where the institution is insolvent (or has severe financial problems) and there is a failure to disclose this, then the making of the deposit should not be interpreted as an acceptance of the risk of the institution's imminent collapse and the depositor's unsecured status. This is discussed below.<sup>14</sup>

The comparison of these transactions indicates that a claim for proprietary relief, based on an objective standard, necessitates an evaluation of market practice. Such an evaluation will vividly contextualise the actions or inactions of both parties. It will draw the court's attention to any practical difficulties (aside from the unconscionable conduct of the insolvent) which the creditor may face in trying to alleviate or pass on risk. In Chapter 3 it was noted that commingling of the funds did not, for some judges, necessarily defeat the proposition that a trust was intended, particularly where segregation was simply not possible.<sup>15</sup> In the seminal case of *In the Matter of Penn Central Transportation Company*<sup>16</sup> the United States Court of

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<sup>10</sup> Dianne Everett and Sheelagh McCracken, *Banking and Financial Institutions Law* (4<sup>th</sup> ed, 1997) Chapter 11; Fidler, above n 9, 270-271.

<sup>11</sup> Fidler, above n 9, 270-271.

<sup>12</sup> For a case where investigation of the purposes of the loan are noted see *Prosperity v Lloyds Bank Ltd* (1923) 39 TLR 372; Fidler, above n 9, 271-272.

<sup>13</sup> Fidler, above n 9, 272-273.

<sup>14</sup> Below, 243-254.

<sup>15</sup> *Stephens Travel Service International Pty Ltd (Receivers and Managers Appointed) v Qantas Airways Ltd* (1988) 13 NSWLR 331, 341-344 (Hope JA).

<sup>16</sup> 486 F (2d) 519 (3<sup>rd</sup> Cir, 1973).

Appeal considered the commingling of moneys issue in the complex context of interline railroad transactions. Penn Central collected moneys as agent for other carriers and deposited them in general, rather than separate, accounts pending distribution to the carriers. The Court held the numerous and varied daily collections precluded the practical segregation of the money.<sup>17</sup> Therefore, Penn Central held the funds collected on trust.

Unfortunately, courts have tended to neglect an evaluation of standard market practice in relation to the individual market transactions. Rather, having established that there is some vitiating factor, such as mistake, which justifies the court holding that the creditor is entitled to proprietary relief, the courts have proceeded to award that relief. This criticism has been made in relation to the decision in *Chase Manhattan Bank NA v Israel-British Bank (London) Ltd* ('Chase').<sup>18</sup> Whilst Goulding J carefully considered equitable principles and remedies, he did not discuss what were then common commercial practices between international banks where money has been transferred electronically by mistake. It was surprising that actions which banks would generally undertake between themselves to remedy mistaken overpayment (which no doubt is a common problem in electronic transfers), was not presented to the Court. Moreover, the machinery of the clearing system was not even considered.<sup>19</sup>

The following discussion addresses particular issues which may be relevant whether the creditor assumed the risk of the commercial transaction. The list is not exhaustive. Rather, the following discussion highlights some major contextual considerations when addressing commercial assumption of risk and insolvency from a practical perspective.

### ***A Ascertaining the Financial Viability of the Insolvent***

Theoretically speaking, it is always open to any kind of creditor (whether secured or unsecured) to undertake some form of investigation in relation to the financial status of the debtor. The extent to which this investigation can be

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<sup>17</sup> Ibid 524-525.

<sup>18</sup> [1981] 1 Ch 105.

<sup>19</sup> Philip R. Wood, 'How Effective is your Security - The Impact of Recent Cases: Linter Case' *Banking Law and Practice, 10th Annual Conference, 13 and 14 May, 1993* (1993), 262, 266.



undertaken via legitimate channels will depend on the jurisdiction which is involved. There are two issues which will, by necessity, arise. First, the nature and extent of the material which is publicly and legitimately available. Secondly, to what extent market practice dictates that the investigation of financial viability of the debtor is necessary. Sometimes, the potential creditor will have the commercial leverage to demand that they have open access to the books of the debtor. If this is the case, then creditors should utilise this capacity to investigate the debtor.

In Australia, material concerning the debtor's financial status which is distinct from the debtor's own records is available at cost to commercial parties. For example, under the *Bankruptcy Act 1966* (Cth), a *National Personal Insolvency Index*<sup>20</sup> has been set up which may be searched (at cost to the searcher) for details of bankrupt individuals and businesses. The *Index* details such matters as the acceptance of debtor's petitions,<sup>21</sup> creditor's petitions,<sup>22</sup> sequestration orders,<sup>23</sup> the annulment of bankruptcy by special resolution of creditors<sup>24</sup> and automatic discharge from bankruptcy.<sup>25</sup>

One apparent omission is the bankruptcy notice issued by the Official Receiver,<sup>26</sup> which is not public information. Bankruptcy notices are not matters for public record until the creditor's petition is issued.<sup>27</sup> Thus, where there is an allegation that there has been an act of bankruptcy, it is unlikely that the party will be deemed to have notice of the act of bankruptcy, unless the party is the creditor who

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<sup>20</sup> Pursuant to the *Bankruptcy Act 1966* (Cth) Regulation 13.03.

<sup>21</sup> *Bankruptcy Act 1966* (Cth) s 55.

<sup>22</sup> *Bankruptcy Act 1966* (Cth) ss 43 and 47.

<sup>23</sup> *Bankruptcy Act 1966* (Cth) ss 43 and 52.

<sup>24</sup> *Bankruptcy Act 1966* (Cth) s 74.

<sup>25</sup> *Bankruptcy Act 1966* (Cth) s 149. For full details of what the *National Personal Insolvency Index* covers see PP McQuade and MGR Gronow, McDonald, Henry and Meek: *Australian Bankruptcy Law and Practice* (5<sup>th</sup> ed, 1996) vol 2, [RF 450.0].

<sup>26</sup> *Bankruptcy Act 1966* (Cth) Regulation 4.01; McQuade and Gronow, above n 25, vol 1, [40.1.156]-[40.1.365]; [RE4.01.0].

<sup>27</sup> McQuade and Gronow, above n 25, vol 2, [RF 450.0]

has sought and obtained the issue of the notice,<sup>28</sup> the party has notice of other acts of bankruptcy or has material from which a reasonable inference of an act of bankruptcy may be drawn.<sup>29</sup> In the light of events leading up to the bankruptcy, the creditor will be at the mercy of the defendant's integrity. As the case law shows, it cannot be assumed that defendants will act appropriately.<sup>30</sup>

Where details of the process of bankruptcy are available, the question is whether parties who deal with the defendant should be imputed with notice of those documents. If evidence is adduced which shows that the creditor did have actual notice of this information, then equity should not be called to intervene and the legislative scheme should simply apply. In *Re M and J de Wit; Ex parte Custom Credit Corporation Ltd*,<sup>31</sup> Paine J held that the creditor was not entitled to relief because the creditor was aware that a bankruptcy petition was due for hearing and from that information, it could be inferred that the creditor knew that the bankrupt had committed an act of bankruptcy. The creditor was aware of the risks involved in dealing with a person so close to formal bankruptcy.<sup>32</sup>

However, under the bankruptcy regime, it appears that the assumption has been and continues to be that, where documents and events are publicly notified, then parties are assumed to have notice of those events and documents even if they do not have actual notice. The problem will be that parties may not take the time to investigate the creditworthiness of a commercial party with which they are dealing. They will not consider that it is necessary to make an investigation of a party which is open for business.

Bankrupts suffer serious consequences if they obtain credit, goods or services without disclosing their bankruptcy to the other party to the transaction.<sup>33</sup> It is likely

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<sup>28</sup> Note *Bankruptcy Act 1966* (Cth) s 41.

<sup>29</sup> In relation to earlier English legislation, *Bankruptcy Act 1914* (UK) s 46 see Muir Hunter, *Williams' Law and Practice in Bankruptcy* (17<sup>th</sup> ed, 1958) 376-377.

<sup>30</sup> Note such cases as *Daly v Sydney Stock Exchange Ltd* (1986) 160 CLR 371; *Westpac Banking Corporation v Savin* [1985] 2 NZLR 41; *Lankshear v ANZ Banking Group (New Zealand) Ltd* [1993] 1 NZLR 481; *Neste Oy v Lloyd's Bank plc* [1983] 2 Lloyd's Rep 658.

<sup>31</sup> (1961) 19 ABC 63.

<sup>32</sup> *Ibid* 71.

<sup>33</sup> See *Bankruptcy Act 1966* (Cth) ss 265 (5) and 269.

that, in most cases, a bankrupt would not attempt to act in ways which contravene the legislative regime. If a bankrupt does so act, then it is strongly arguable that the bankrupt has acted unconscionably.

However, the fact that the information of the bankruptcy is publicly available may be a factor which will ultimately go against a creditor. In *Re Ayoub; Ex parte Silvia*<sup>34</sup> a bankrupt commenced operating as a liquor merchant and purchased stock after the issue of a sequestration order of which the creditors were unaware. When the Official Receiver in bankruptcy became aware of the business, he took over the business on a cash on delivery basis. The Official Receiver subsequently sold the business. One of the issues was whether the subsequent unsecured suppliers took priority over the other earlier unsecured creditors. Morling J held, inter alia, that the business had not been undertaken originally on the basis that the subsequent suppliers would be paid for the goods. The suppliers were unsuccessful because they assumed the risk of the insolvency when they could have easily investigated the bankrupt's creditworthiness and decided not to do so.<sup>35</sup>

Where the information concerning creditworthiness is available, it is likely that courts will invariably distinguish two different scenarios (between which there are wide ranging permutations). The first scenario is where the creditor is involved in business on a regular basis and at least part of the undertaking of that business is the transfer (or loan) of funds or the supply of goods to customers. Another situation is where financial institutions and large department stores provide credit for the purchase of goods. It would be part of normal commercial practice to make a thorough investigation of the creditworthiness of an applicant (whether corporate or individual). This would include undertaking searches of the relevant insolvency register or paying search agencies to do so on their behalf. Whilst the comments here are generally limited to the investigations of the data available in relation to insolvencies, if there were other legitimate forms of investigation, courts may well decide, in the light of the nature of the business operations, that search of these data bases may become necessary. Therefore, the creditor bears an onus to undertake investigations of creditworthiness. The cost of these measures can be built into the overall cost of the transaction, so that the debtor would effectively pay for the costs

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<sup>34</sup> (1983) 67 FLR 144.

<sup>35</sup> Ibid 149. See also *Downs Distributing Company Pty Ltd v Associated Blue Star Stores Pty Ltd* [1948] 76 CLR 463, 484 (Williams J) and *Re Gozzett; Ex parte Messenger & Co Ltd v The Trustee* (1936) 1 All ER 79.

of the search. If a creditor ascertains that the applicant lacked creditworthiness, then the creditor has notice of the financial problems and if that creditor proceeds with the transaction (which it would probably be well advised not to), the creditor bears the risk as an unsecured creditor. The creditor should not be able to obtain equitable proprietary intervention. Where the searches indicate that there are no financial problems, if these problems surface at a later stage then the creditor may be entitled to seek the assistance of equity.

The second scenario is where the party does not carry on business or is carrying on business which does not require these kinds of investigations on a regular basis. Consumers cannot be expected to add to their transaction costs by undertaking insolvency searches. For example, the vendors in *Westpac Banking Corporation v Savin*,<sup>36</sup> who had hired an agent to sell their boats, were not admonished by the New Zealand Court of Appeal for failing to undertake searches about the creditworthiness and financial status of the agent. They were not required to make such investigations. Their claims for relief were not impaired by the fact that they had not made them.

***B Whether the Creditor was able to Protect Itself from Risk by Requiring Security or Imposing Conditions on How the Money was to be Kept and/or Used***

Another issue is whether the unsecured creditor was in a position to require security and/or impose conditions on how the money should be kept and/or used. Theoretically speaking, it is possible for any lender, wholesaler and consumer to seek security from a borrower, retailer or supplier. But, in the end result, theoretical possibilities take second place to the practical realities of the market. Depositors, principals, mistaken payers, insurers and guarantors are not in the habit of taking security to protect themselves. Indeed, to do so may render the transaction farcical, unnecessarily expensive and lead to an impediment in the flow of funds. However, insurers have the opportunity to offset the insurance risk via reinsurance.<sup>37</sup>

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<sup>36</sup> [1985] 2 NZLR 41.

<sup>37</sup> For a comprehensive discussion of reinsurance see RL Carter, *Reinsurance* (1979) and Ross Phifer, *Reinsurance Fundamentals: Treaty and Facultative* (1996). For a discussion of the Australian context see Kenneth Sutton, *Insurance Law in Australia* (2<sup>nd</sup> ed, 1991) Chapter 17.

Lenders are generally in a good position to require borrowers to provide security in one form or another. The type of security will depend on a borrower's asset base and the extent of the borrower's liability. Obviously, each case will need to be determined on its own merits. But, a lender should bear an onus to protect its interests (and indirectly the interests of its customers). A lender would need to adduce evidence that there had been a good reason why it had not taken security because a strong presumption must be that the lender assumed the risk of having the low priority of an unsecured creditor. If the nature of the loan was one which was not secured, such as short term credit with high interest, the lender ought to be deemed to have assumed the risk of an unsecured creditor. Where the lender had originally stipulated that security was necessary, but had later withdrawn from that position, then the lender had assumed the risk of being an unsecured creditor.

In contrast, depositors in financial institutions (despite their characterisation as creditors)<sup>38</sup> do not have the practical leverage to require the financial institution to provide security for the deposit. Even relatively large corporate depositors or depositors who have deposited a considerable amount of money in a financial institution, are not likely to succeed. Both market practice and the general characterisation of the relationship between depositors and banks as unsecured creditors set the parameters of the relationships. If the situation were otherwise, then the nature and function of financial transactions would be unnecessarily bogged down, transaction costs would rise and the financial institutions may be in an uncompetitive position.

Another situation arises in relation to the electronic transfers of money. In *Chase*<sup>39</sup> the fact that the transferring bank had not acquired security from the transferee in the event that moneys could be paid over by mistake, did not detrimentally affect its action based on mistake of fact. The fact that security had not been demanded, let alone actually acquired, was not even raised. It was simply assumed that the relationship of the parties was such that it was not part of market practice between banks to acquire security from one another. It is not in the best interests of a finance provider to provide security over their business or the assets of their business to a potential competitor.

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<sup>38</sup> *Foley v Hill* (1848) 2 HL Cas 28; 9 ER 1002; *N Joachimson (A Firm Name) v Swiss Bank Corporation* [1921] 3 KB 110; EP Ellinger and Eva Lomnicka, *Modern Banking Law* (2<sup>nd</sup> ed, 1994) 107-111.

<sup>39</sup> [1981] 1 Ch 105.

Where customers (or principals) are concerned, it is equally unlikely that security would be available over the vendor's (or agent's) assets.<sup>40</sup> In *Walker v Corboy*<sup>41</sup> farmers forwarded produce to agents for sale on a regular basis. These transactions were regulated by legislation which, in accordance with market practice, did not provide for security over the agent's assets.<sup>42</sup> The only way that the farmers could have obtained a security status was proof of a trust over their own assets and the proceeds of sale of their assets. However, they were unsuccessful.<sup>43</sup>

The converse situation (in terms of the trust successfully used as a security) was the decision in *Re Kayford (in liq)*.<sup>44</sup> It was evident that mail order customers were not in the habit of asking for security over the pre-payments which were made. From the judgment there appears no suggestion that mail order customers should or could insist on security. The interesting development in *Re Kayford (in liq)* was that the Court acknowledged and accepted the attempts of the company to provide a quasi-security when it began to suffer financial difficulties.

### ***C Credit Insurance***

The concept of credit insurance (also referred to as guarantee or financial insurance) is allied to the taking of security. In order to secure protection against the inability of the debtor to fulfil its financial obligations, the creditor effects insurance under which the insurer agrees to insure the creditor, in the event that the debtor fails to honour its debts. The creditor will not need to stand alongside other unsecured creditors and seek payment from the debtor's scarce assets in the event of the debtor's insolvency. Unlike security, credit insurance is a means by which the credit insured transfers the risk of insolvency to a third party on the payment of a price. If the insurer becomes liable under the contract, then the insurer will honour that liability. As an unsecured creditor (standing in the shoes of the original creditor), the

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<sup>40</sup> See for example *Westpac Banking Corporation v Savin* [1985] 2 NZLR 41; *Neste Oy v Lloyds Bank plc* [1983] 2 Lloyd's Rep 658.

<sup>41</sup> (1990) 19 NSWLR 382.

<sup>42</sup> *Farm Produce Act 1983* (NSW).

<sup>43</sup> (1990) 19 NSWLR 382, 397-398 (Meagher JA).

<sup>44</sup> [1975] 1 WLR 279.

insurer will bring an action against the debtor pursuant to the doctrine of subrogation.<sup>45</sup>

The insurance may relate to a particular debt such as a loan,<sup>46</sup> debts in general<sup>47</sup> or any debts which the debtor may owe the creditor after the insurance is in operation.<sup>48</sup> It will depend on the terms of the policy when the insurer becomes liable to the insured. Liability may arise on the basis of non-payment of the debt when it falls due<sup>49</sup> or on the insolvency of the debtor.<sup>50</sup> Such insurance usually contains a provision in which, the creditor agrees not to modify its rights and remedies against the debtor.<sup>51</sup>

Whilst it is theoretically possible for a creditor to take out credit insurance, each case will be determined by market practice. There are several potential problems. One difficulty may be that credit insurance may not be available to the creditor on acceptable terms. Credit insurance is not as common as life, fire or accident insurance and there may be less choice as to the kind of insurance product available.

Even if there are credit insurance packages available, the question will be whether credit insurance is acceptable in market practice. It is likely that large and/or permanent market players would benefit most from taking out credit insurance over potentially risky debtors. However, taking out credit insurance may not be

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<sup>45</sup> Michael Parkington (ed), *MacGillivray & Parkington on Insurance Law* (7<sup>th</sup> ed, 1981), [2135]-[2146]. As to the operation of credit insurance in Australia and its relationship to credit legislation see *CCH Australian & New Zealand Insurance Reporter* (1979-) Vol 1, ¶ 1-660; *Swann Insurance (Aust) Pty Ltd v Fraillon* [1992] 1 VR 401 and the comment on the case in (1991) 6 *Australian Insurance Law Bulletin* 82.

<sup>46</sup> *Parr's Bank v Albert Mines Syndicate Ltd* (1900) 5 Com Cas 116.

<sup>47</sup> *Solvency Mutual Guarantee Co v York* (1858) 3 H & N 588; 157 ER 603; *Solvency Mutual Guarantee Co v Froane* (1861) 7 H & N 5; 158 ER 369; *Solvency Mutual Guarantee Co v Freeman* (1861) 7 H & N 17; 158 ER 374.

<sup>48</sup> *Seaton v Burnand* [1900] AC 135; *Anglo-Californian Bank Ltd v London and Provincial Marine and General Insurance Co Ltd* (1904) 10 Com Cas 1.

<sup>49</sup> *Shaw v Royce Ltd* [1911] 1 Ch 138.

<sup>50</sup> *Hambro v Burnand* [1904] 2 KB 10; *Waterkeyn v Eagle Star Insurance Co* (1920) 5 LI LR 42.

<sup>51</sup> *Finlay v The Mexican Investment Corporation* [1897] 1 QB 517.

financially viable. The credit insurance may add to the creditor's, and accordingly, the debtor's transaction costs to the extent that the transaction becomes unattractive from the debtor's point of view. Credit insurance may take time to effect and the debtor may be unwilling to wait for an insurer to undertake the necessary financial investigations prior to issuing insurance. The debtor may resent having a third party, such as an insurance company, inspect its records of assets and financial transactions (particularly when the insurance is for the benefit of the creditor not the debtor).

Finally, the insurance company may not wish to assume the commercial risk associated with some debtors. This may signify to a creditor that it should re-evaluate its original intention to deal with the potential debtor. If the creditor proceeded with the transaction, this may in itself constitute evidence that the creditor took on the commercial risk of the debtor's potential insolvency.

Generally speaking, if there is sufficient evidence to suggest that credit insurance is available and part of market practice, then the failure of the creditor to effect such insurance should become a potent factor against equitable relief.

### ***D Deposit Insurance***

Linked to the passing of risk via credit insurance, there is also the possibility that deposit insurance will be available for customers of financial institutions. The rationale for deposit insurance is not simply the passing of risk and the protection of small depositors. By enabling small depositors to pass on risk by obtaining deposit insurance, a degree of economic stability may be sustained in the event of the collapse of the financial institution.<sup>52</sup>

Despite the various reasons which underlie deposit insurance as an institution, the basic question in insolvency situations will be whether it was available to creditors. Where deposit insurance is available in common law countries such as the United States and Canada,<sup>53</sup> it is arguable that the failure to take protective steps, leads to a strong inference that the creditor assumed the risk of insolvency. This inference would be partly offset where the deposit insurance is limited in some way. For example, the deposit insurance may be available to insure

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<sup>52</sup> Herbert G Grubel, *A Proposal for the Establishment of an International Deposit Insurance Corporation* (1979) 10-11.

<sup>53</sup> Ibid.



small accounts only. It may be available for certain kinds of customers only - large depositors may be left to negotiate complex arrangements which stand outside the deposit insurance norm.

Where there is no regime for deposit insurance, then the creditor does not have the opportunity to offset the potential insolvency of the financial institution. This is the case in Australia where recently, the Wallis Committee stated that on balance that there was no need for a deposit insurance scheme in the light of other banking arrangements.<sup>54</sup> Such arrangements include the provisions which deal with banking failure under the *Banking Act* 1959 (Cth). Under Division 2 'Protection of Depositors', where a bank is unable to meet its obligations or suspending payment, the assets of the bank are required to be used to meet deposit liabilities prior to all other liabilities of the bank.<sup>55</sup> Section 16 (2) of the *Banking Act* requires that unless authorised by the Reserve Bank of Australia, a bank shall hold assets (other than goodwill) in Australia of a value not less than the total amount of its deposit liabilities in Australia. These provisions have not been tested in court, so it is unclear how well they would operate to protect depositors.<sup>56</sup> However, in comparison, depositors in building societies or credit unions are not accorded such priority under the relevant legislation which controls them.<sup>57</sup>

### ***E Transaction Costs***

Transaction costs are those necessary costs which are associated with minor and subordinate actions which lead to the successful completion of a commercial transaction. Such costs may occur at the commencement of or during the transaction, such as various searches in relation to the borrower. Other costs may occur at the end of the transaction, such as the registration of the interests of a purchaser in land or a new security holder's interest under a company charge.

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<sup>54</sup> *Financial System Inquiry Final Report* (1997) 355.

<sup>55</sup> *Banking Act* 1959 (Cth) s 16 (1).

<sup>56</sup> *Financial System Inquiry Final Report* (1997) 354.

<sup>57</sup> *Ibid.*

There are some transaction costs which are necessary for satisfactory completion. For example, registration of a chargee's interest may be necessary in order to ensure that the chargee's interest is fully protected and/or realisable.<sup>58</sup>

However, there are other actions which are not absolutely necessary to carry out the transaction, but they are highly prudential. The extent to which non-mandatory transaction costs become important determinants of the assumption of risk of commercial transactions will depend on the time taken to undertake the non-mandatory prudential transaction, the cost of the prudential action and its cost in relation to the overall transaction. Time and cost sustain vastly different market practices. So for example, in loan transactions, banks generally have the opportunity to demand time to complete various searches and enquiries about the borrower and search costs are ultimately borne by the borrower. These costs are generally in proportion to the value of the transaction and the risk assumed by the bank. In comparison, depositors of funds in financial institutions, do not have the time or the resources to investigate the financial status of such institutions each time a deposit is made. The cost of undertaking searches in relation to the financial stability of the institution may be completely disproportionate to the search costs.

## **F Review**

The above discussion has emphasised the need for an understanding of the market context and practical market expectations of creditor conduct. In some commercial transactions, practical market expectations will, objectively speaking, dictate that an aggrieved creditor should have taken steps to protect his or her own interests. Where this is determined, then *prima facie*, that creditor should not be entitled to proprietary relief. It should not obtain priority over other unsecured creditors - particularly those unsecured creditors who, unlike that creditor, did not have an array of protective measures at their disposal. Objectively speaking, the creditor was expected to minimise the risk of the commercial transaction in the light of the milieu in which the commercial transaction took place. However, the creditor may still be able to secure proprietary relief, if the creditor can show that the insolvent's unconscionable conduct effectively prevented the creditor from taking standard risk minimisation measures. Thus, the creditor could not be expected to minimise the commercial risk.

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<sup>58</sup> Note for example, *Corporations Law* Part 3.5, ss 262 and 266.

Where a creditor could not be expected to minimise the transaction risk, that creditor would have to address item (iv), namely, whether the insolvent's conduct was unconscionable.

### III THE DEFENDANT'S UNCONSCIONABLE CONDUCT

For the purposes of the discussion, unconscionable conduct will be evaluated under three broad divisions, unconscionable conduct outside a commercial transaction, unconscionable conduct prior to or at the time the commercial transaction commences and unconscionable conduct after the commercial transaction commences.

#### *A Unconscionable Conduct Outside a Commercial Transaction*

For the sake of completeness, it is necessary to consider a situation where a party acts unconscionably outside a consensual commercial transaction. Equity has provided relief in cases of actual wrongdoing (such as fraudulent misrepresentation).<sup>59</sup> However, outside commercial transactions, there are cases where there has been deliberate wrongdoing which may expose another to the insolvency of the wrongdoer. In such cases, proprietary relief ought to be available.

A common example would be where one party stole money from another. In *Black v S Freedman & Co*,<sup>60</sup> the appellant employee stole money from the respondent employer. The appellant gave the stolen money to his wife, the second appellant. The respondent was successful in the claim against the wife. It was held that the employee owed fiduciary obligations to his employer.<sup>61</sup> Therefore, the respondent's proprietary interest in the money was linked to the fiduciary relationship. However, O'Connor J said that equity would intervene where there was a simple theft.<sup>62</sup>

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<sup>59</sup> *Earl of Chesterfield v Janssen* (1751) 2 Ves Sen 125, 155; 28 ER 82, 100 (Lord Hardwicke); LA Sheridan, *Fraud in Equity* (1957) 10-51.

<sup>60</sup> [1910] 12 CLR 105.

<sup>61</sup> Note Patrick Parkinson, 'Fiduciary Obligations' in Patrick Parkinson (ed), *The Principles of Equity*, (1996) 325, [1003].

<sup>62</sup> [1910] 12 CLR 105, 110; See also *Spedding v Spedding* (1913) 30 WN (NSW) 81; *Rasmanis v Jurewitsch* (1970) 70 SR (NSW) 407; *Zobory v Federal Commissioner of Taxation* (1995) 129 ALR

The interposition of equity has also been supported by academic writers<sup>63</sup> although the mechanisms identified have been different.<sup>64</sup> Theft is a criminal offence and is subject to moral opprobrium and rigorous legislative sanctions.<sup>65</sup> On this basis alone, it would be surprising (if not ludicrous) if the creditor was not entitled to proprietary relief in the situation where a thief had become insolvent.

However, applying the approach to proprietary relief which has been posited, a creditor would not be expected to minimise risk of theft as against the thief who perpetrated the crime. Therefore, the creditor would be entitled to proprietary relief against the thief in priority to the thief's other unsecured creditors (who had taken on the normal commercial risk of the thief's potential insolvency). Even if the party had availed the opportunity presented of insuring the property and successfully claimed under the insurance, it is strongly arguable that the thief would be required to disgorge the property acquired by his wrongdoing to an insurer on the basis of subrogation.<sup>66</sup> In addition, the theft cases show clearly the absurdity of insisting on the traceability of the proceeds of the crime.<sup>67</sup> Instead, the proof of theft beyond reasonable doubt,<sup>68</sup> should be sufficient to entitle a creditor to proprietary relief.

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484, 487 (Burchett J); *Australian Postal Corporation v Lutak* (1991) 21 NSWLR 584, 589 (Bryson J); *Lennox Industries (Canada) Ltd v The Queen* (1937) 34 DLR (4th) 297, 304 (Reed J); *Goodbody v Bank of Montreal* (1974) 47 DLR (3d) 335; *Westdeutsche Landesbank Girozentrale v Islington Borough Council* [1996] AC 669, 715-716 (Lord Browne-Wilkinson).

<sup>63</sup> Austin Wakeman Scott and William Franklin Fratcher, *The Law of Trusts* (4<sup>th</sup> ed, 1989), vol V, § 508.1; Malcolm Cope, *Proprietary Claims and Remedies* (1997) 90; AJ Oakley, *Constructive Trusts* (3<sup>rd</sup> ed, 1997) 46-53; and Helen Norman, 'Tracing the Proceeds of Crime: an Inequitable Solution?' in Peter Birks (ed), *Laundering and Tracing* (1997) 95, 102.

<sup>64</sup> RP Meagher and WMC Gummow, *Jacobs' Law of Trusts* (6<sup>th</sup> ed, 1997) [1310]. In relation to conversion see Scott and Fratcher, above n 63, vol V, § 508.1; The Hon Mr Justice Peter J Millett, 'Tracing the Proceeds of Fraud' in Stephen Goldstein (ed), *Equity and Contemporary Legal Developments* (1992) 407, 413-414; Norman, above n 63, 102.

<sup>65</sup> See for example *the Theft Act 1968* (UK) (supplemented by the *Theft Act 1978*); Peter Gillies, *Criminal Law* (4<sup>th</sup> ed, 1997) Chapter 19 (New South Wales and South Australia) and Chapter 22 (Victoria and ACT).

<sup>66</sup> For a discussion of subrogation see Chapter 2, 77-80.

<sup>67</sup> See for example, Norman, above n 63, 95.

<sup>68</sup> *Evidence Act 1995* (Cth) s140 (1).

## ***B Unconscionable Conduct Prior to or at the Time of the Commercial Transaction***

A major area of scrutiny will be the conduct of the insolvent prior to or at the time of the transaction which in some way induced the creditor to enter the transaction. Such conduct may severely curtail the capacity of a creditor to take appropriate action to minimise risk. The conduct is divisible into two segments. There are situations where the insolvent's conduct is unconscionable in an active sense. Alternatively, there is conduct where the insolvent has passively (but purposively) induced the creditor to enter into the transaction.

### ***1 Active Unconscionable Conduct***

The three major situations are fraudulent misrepresentation, proprietary estoppel and the active exploitation of vulnerability by the application of pressure on the creditor.

#### ***(a) Fraudulent Misrepresentation***

Fraudulent misrepresentation (which is distinct from the form of misrepresentation known as innocent misrepresentation) is essentially an action which was available at common law. The major requirement is that the representation was made with knowledge of its falsity<sup>69</sup> and with actual dishonesty.<sup>70</sup> The fraudulent representation must induce the contract and have a causal connection with the contract.<sup>71</sup> If the creditor can show that there is a fraudulent misrepresentation, then he may affirm the contract and bring a tortious action of

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<sup>69</sup> Note in this regard *Derry v Peek* (1889) 14 App Cas 337, 374 (Lord Herschell); cf Sheridan, above n 59, 12-13, 17-24; RP Meagher, WMC Gummow and JRF Leane, *Equity Doctrines and Remedies* (3<sup>rd</sup> ed, 1992) [1301]; Tony Duggan, 'Misrepresentation' in Patrick Parkinson (ed), *The Principles of Equity* (1996) 158, [602].

<sup>70</sup> Duggan, above n 69, [602].

<sup>71</sup> Ibid; *Gipps v Gipps* [1978] 1 NSWLR 454, 460 (Hutley JA).

deceit,<sup>72</sup> sue for breach of warranty, where the fraudulent misrepresentation has been incorporated into the contract<sup>73</sup> or rescind the contract.<sup>74</sup>

The general rationale for an action based on fraudulent misrepresentation is that a party should not be entitled to benefit from the creation of a false impression or the making of a false statement.<sup>75</sup> However, where proprietary relief is sought, the basis for proprietary relief ought to be that, due to the fraudulent misrepresentation the creditor was not fully informed of the risks associated with the transaction.

The proprietary potential of fraudulent misrepresentation was evident in the New Zealand Court of Appeal decision in *Liggett v Kensington*<sup>76</sup> although this was not fully appreciated or apparently argued. Investors paid funds to a bullion dealer for the purchase of bullion on the basis, inter alia, that the bullion which they purchased would be segregated from the large mass and, they would have title in the bullion. The bullion dealer became insolvent. Cooke P held that a fiduciary relationship arose as the bullion dealer had obtained funds via the misrepresentation. Therefore, the investors were entitled to proprietary relief in priority to not only unsecured creditors but a floating chargee.<sup>77</sup> On appeal to the Privy Council, Lord Mustill held that the investors had intended to transfer the money, so that they could not argue that they retained title to the money. Whilst they may have been entitled to have the contract set aside and obtain personal relief, they were not entitled to proprietary relief.<sup>78</sup>

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<sup>72</sup> *Munchies Management Pty Ltd v Belperio* (1988) 84 ALR 700, 706 (Fisher, Gummow and Lee JJ).

<sup>73</sup> *Alati v Kruger* (1955) 94 CLR 216, 222 (Dixon, Webb, Kitto and Taylor JJ).

<sup>74</sup> *Kennedy v The Panama, New Zealand & Australian Royal Mail Co Ltd* (1867) LR 2 QB 580.

<sup>75</sup> DW Greig and JLR Davis, *The Law of Contract* (1987) 827-828.

<sup>76</sup> [1993] 1 NZLR 257.

<sup>77</sup> Ibid 270-271; See also *Australian Securities Commission v Melbourne Asset Management Nominees Pty Ltd* (1994) 49 FCR 334 and note in the Canadian context *Hunter Engineering Inc (Hunter Machinery Canada Ltd), Integrated Metal Systems Canada Ltd and Allis-Chalmers Canada Ltd v Syncrude Canada Ltd* [1989] 1 SCR 426; (1989) 35 BCLR (2d) 145.

<sup>78</sup> *Re Goldcorp Exchange Ltd (In Receivership)* [1995] 1 AC 74, 100-105.

It is submitted that the customers were entitled to proprietary relief. There was a fraudulent misrepresentation by the bullion dealer which induced the investors to pay over funds, because the company took no action to segregate the bullion as represented. It is likely that the investors would have been less inclined to do so if they had been informed that the gold dealer had no intention of undertaking its apparent contractual obligations in relation to segregation of the assets (with the effect that the investors would not have had title to the bullion). Therefore, there was a direct nexus between the unconscionable conduct and the investor's unsecured state.

### ***(b) Proprietary Estoppel***

As discussed below, claims based on equitable estoppel for incomplete or anticipated contracts may entitle a creditor to personal relief. It is unlikely proprietary relief will be available.<sup>79</sup>

However, a party may be successful where he proves that the other party represented<sup>80</sup> to him a present or future intention as to his proprietary status and the party acted to his detriment on the basis of that representation.<sup>81</sup> The other party then attempts to resile from the representation. This amounts to unconscionable conduct. If the party shows that nothing less than compliance with the representation will remedy the defendant's unconscionable conduct, then the party may obtain proprietary relief.<sup>82</sup> This was the result of proprietary estoppel cases which concerned representations made in relation to land.<sup>83</sup>

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<sup>79</sup> Below, 263-264; 266.

<sup>80</sup> In relation to representations see for example *Waltons Stores (Interstate) Pty Ltd v Maher* (1988) 164 CLR 387; *Commonwealth v Verwayen* (1990) 170 CLR 394; *Legione v Hateley* (1983) 152 CLR 406; *Marine Steel Ltd v The Ship 'Steel Navigator'* [1992] 1 NZLR 77.

<sup>81</sup> Ibid.

<sup>82</sup> In relation to the criteria applied see for example *Commonwealth v Verwayen* (1990) 170 CLR 394; *Commonwealth v Clark* [1994] 2 VR 333.

<sup>83</sup> *Crabb v Arun District Council* [1976] Ch 179; *Morris v Morris* [1982] 1 NSWLR 61; *Riches v Hogben* (1986) 1 Qd R 315; Patrick Parkinson, 'Estoppel' in Patrick Parkinson (ed), *The Principles of Equity* (1996) 201, [712].

In the light of the theory of objective non-assumption of risk, it is arguable that a representation about a party's security status could be treated in a similar fashion where detrimental reliance upon the representation is shown. This is the analysis which could have been undertaken in *Banque Financière de la Cité v Parc (Battersea) Ltd*<sup>84</sup> the facts of which are considered in Chapter 3.<sup>85</sup> Instead of distorting the law of subrogation, an argument based on equitable proprietary estoppel would have been more effective. The manager of the corporate group made a written representation that in the future the creditor would be treated as a secured creditor in priority to the other members of the corporate group. The creditor made the loan accommodation available relying on the written representation. In the light of the unusual financial arrangements and the representations of the manager, the creditor did not take steps to protect its interests in conformity with market practice.<sup>86</sup> Thus, it did not assume the risk of insolvency of the defendant. The subsequent unconscientious failure of the defendant to comply with the representation would have directly contributed to the unsecured status. It was necessary for equity to intervene and compel the defendant to treat the creditor as if the creditor had security which entitled it to priority over other corporate members of the group. Although it can be argued that the ultimate unconscionability would have been the failure to comply with the representation, it was the representation which induced the creditor to act to its detriment. Therefore, both the representation and the failure to adhere to it constituted unconscionable conduct.

## **2 Active Exploitation of Vulnerability**

There are occasions where it can be said that despite the fact that parties are required to protect themselves, they are unable to do so, due to their innate

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<sup>84</sup> [1998] 2 WLR 475.

<sup>85</sup> Chapter 3, 131-132.

<sup>86</sup> [1998] 2 WLR 475, 477 (Lord Steyn); 480-483 (Lord Hoffman).



vulnerability and/or the inordinate pressure placed upon them.<sup>87</sup> Common law duress and actual undue influence are examples of such pressure.<sup>88</sup>

### **(a) Duress**

The common law has identified that actual pressure or threats may require remedial relief. The parties involved may be at arm's-length, but the actual or threatened coercion is of such a serious nature that courts intervene. In order to secure relief, a creditor is required to establish that there has been an improper or illegitimate pressure from which the defendant has received a benefit.<sup>89</sup>

Where there has been actual or threatened violence to the person,<sup>90</sup> the transaction is voidable.<sup>91</sup> Presumably, there is a right to recover money paid pursuant to actual physical coercion or threats of coercion, although it has not been directly decided.<sup>92</sup> Where there has been a threat to seize or detain a person's goods, money paid in response to the threat will also be recoverable.<sup>93</sup> A contract which is induced by duress to goods is voidable.<sup>94</sup>

The controversial issue is whether courts should set aside benefits obtained in the course of exercising commercial pressure. In Australia, two leading judges have

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<sup>87</sup> *Johnson v Buttress* (1936) 56 CLR 113; *Bank of New South Wales v Rogers* (1941) 65 CLR 42; *Wilton v Farnworth* (1948) 76 CLR 646; *Blomley v Ryan* (1956) 99 CLR 362; *Bester v Perpetual Trustee Co Ltd* [1970] 3 NSW 30; *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447.

<sup>88</sup> In relation to proprietary relief in such cases see Scott and Fratcher above, n 63, vol V, § 468.

<sup>89</sup> *Universe Tankships Inc of Monrovia v International Transport Workers Federation* [1983] 1 AC 366; *Dimskal Shipping Co SA v International Transport Workers Federation*. [1992] 2 AC 152.

<sup>90</sup> Lord Goff of Chieveley and Gareth Jones, *The Law of Restitution*, (4<sup>th</sup> ed, 1993) 234.

<sup>91</sup> *Scott v Sebright* (1886) 12 PD 21; *Barton v Armstrong* [1976] AC 104.

<sup>92</sup> Goff and Jones, above n 90, 234.

<sup>93</sup> *Astley v Reynolds* (1731) 2 Strange. 915; 93 ER 939; *Snowdon v Davis* (1808) 1 Taunt 359; 127 ER 872; *Maskell v Horner* [1915] 3 KB 106; *Valpy v Manley* (1845) 1 CB 594; 135 ER 673.

<sup>94</sup> *Dimskal Shipping Co SA v International Transport Workers Federation* [1992] 2 AC 152; *North Ocean Shipping Co Ltd v Hyundai Construction Co Ltd* [1979] QB 705; *Pao On v Lau Yiu Long* [1980] AC 614; cf the earlier authority *Skeate v Beale* (1841) 11 Ad & E 983; 113 ER 688.

taken very different views. McHugh JA (as he then was) in *Crescendo Management Pty Ltd v Westpac Banking Corporation*<sup>95</sup> held, obiter dicta, that the common law would intervene to redress economic duress.<sup>96</sup> In contrast, Kirby P (as he then was) in *Equiticorp Finance Ltd (in liq) v Bank of New Zealand*<sup>97</sup> held that the concept of economic duress, an 'open-ended formulae,' led to the dangerous situation of courts substituting their views about commercial transactions and created uncertainty in commercial transactions.<sup>98</sup> He pointed out that the doctrine of economic duress may simply be part of the law of undue influence or unconscionable dealings.<sup>99</sup> The extent to which economic duress is part of equitable doctrine, rather than common law doctrine, remains to be seen.

Whilst the kinds of situations which will constitute economic duress are not closed,<sup>100</sup> some commentators have drawn attention to the fact that the determination whether a threat is illegitimate pressure may, on occasions, be difficult and will be divided on the facts.<sup>101</sup> Nonetheless, it appears that at this stage, economic duress has become part of the common law, alongside duress to person and goods.

The question in the context of this thesis is whether a person subject to illegitimate commercial pressure should be able to not only seek personal remedies, but whether in the case of the insolvency of the wrongdoer, proprietary relief should be available as well. Goff and Jones have opined (with which this author agrees):

There is no authority on the question whether a person who pays money or confers some other benefit under duress has, in addition to a personal claim, a restitutionary proprietary claim. In our view the

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<sup>95</sup> (1988) 19 NSWLR 40. See also Keith Mason and JW Carter, *Restitution Law in Australia*, (1995) [540] and Peter Birks, 'The Travails of Duress' [1990] *Lloyd's Maritime and Commercial Law Quarterly* 342, 343-344.

<sup>96</sup> *Ibid* 45-47.

<sup>97</sup> (1993) 32 NSWLR 50.

<sup>98</sup> *Ibid* 107.

<sup>99</sup> *Ibid*.

<sup>100</sup> For a list of factors see Mason and Carter, above n 95 [542].

<sup>101</sup> See generally MP Sidone, 'The Doctrine of Economic Duress,' [1996] 14 *Australian Bar Review* Part 2, 114; Goff and Jones, above n 90, 266-268.

courts should grant the coerced person such a claim and should not be inhibited from doing so by the absence of any fiduciary relationship... it would not normally be just to allow, on an insolvency, the general creditors of the person exercising duress to share in the fund, obtained by their debtor, as a result of the debtor's illegitimate pressure exercised on the claimant.<sup>102</sup>

A party who acts under illegitimate pressure exerted by an insolvent does not assume the risks associated with the commercial transaction, including the potential insolvency of that insolvent. He has not acted independently - even though he may be aware of the risks involved and has been unable to take protective measures.

### ***(b) Actual Undue Influence***

In addition to common law duress, equity has settled a general concept of undue influence under which contracts and gifts are set aside.<sup>103</sup> Generally, it will be shown that a party did not exercise independent judgement due to the actual undue influence and that the party was not afforded the opportunity to acquire independent advice.<sup>104</sup> Unable to act independently, the party is often unaware of the risks associated with the transaction. It would be incongruous if an insolvent exercising undue influence was able to retain funds which he had acquired by the exercise of influence.

The doctrine of *actual* undue influence is particularly effective. In *Bank of Credit & Commerce International SA v Aboody*,<sup>105</sup> the defendants were a married couple who were directors of a family company. The company had borrowed money which was secured by the wife's interest in the matrimonial home. The company collapsed and the creditor bank sought to exercise its contractual rights under the securities. The wife challenged the validity of the securities on the basis that they had been procured by the actual undue influence of the husband of which the bank had notice. The wife was ultimately unsuccessful, but the case did shed light on the kind

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<sup>102</sup> Goff and Jones, above n 90, 275. But note here Scott and Fratcher, above n 63 vol V, § 468.

<sup>103</sup> Tony Duggan, 'Undue Influence' in Patrick Parkinson (ed), *The Principles of Equity* (1996) 379, [1101]-1107]; Sheridan, above n 59, Chapter 5.

<sup>104</sup> Duggan, above n 103, [1108].

<sup>105</sup> *Bank of Credit & Commerce International SA v Aboody* [1990] 1 QB 923.

of conduct which constitutes actual undue influence. The English Court of Appeal did find that the husband had acted in a way which had prevented the wife from deliberating upon the commercial risks in an impartial fashion. The husband entered the solicitor's room and insisted in an aggressive fashion that the wife sign the documents.<sup>106</sup> The wife compliantly signed the documents without a full and informed discussion with the solicitor of the risks involved.<sup>107</sup> There was also evidence that the husband deliberately concealed information from the wife about the risks.<sup>108</sup>

Another (but less common) example of actual undue influence is the threat to prosecute a party or a close relative of the party, unless they entered into a contract or pay over money.<sup>109</sup> Such an example of undue influence is closely aligned to the common law concept of duress.

It could be argued that there is a growing merger and overlap of duress and actual undue influence. In both common law duress and actual undue influence the person upon whom the pressure is exerted is unable to exercise independent judgment and commercial freedom. The aggrieved party is pushed into a transaction. In actual undue influence, this is exacerbated because the aggrieved party has acted without an understanding of the commercial risks inherent in the transaction. Therefore, in both duress and actual undue influence cases, it can be said that the aggrieved party did not willingly assume the risk of the commercial transaction. Thus, objectively speaking, a creditor could not be expected to minimise the risk of the commercial transaction in the light of the duress or actual undue influence exerted by the insolvent.<sup>110</sup>

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<sup>106</sup> Ibid 951-952.

<sup>107</sup> Ibid.

<sup>108</sup> Ibid.

<sup>109</sup> *Williams v Bayley* (1866) LR 1 HL 200; *Davies v London & Provincial Marine Insurance Co* (1878) 8 Ch D 469; *Public Service Employees Credit Union Co-operative Ltd v Champion* (1984) 75 FLR 131.

<sup>110</sup> For a discussion of undue influence and proprietary relief in the form of a constructive trusts see Oakley, above n 63, 35-46.

### ***(c) Legal Compulsion***

Finally, for completeness, it is necessary to note those occasions where there is legal compulsion as distinct from duress or actual undue influence described above. In the legal compulsion cases the facts of the situation may compel one party to pay for the liabilities of the other party.<sup>111</sup> Therefore, a debtor-creditor relationship arises. It may be impossible for the creditor to access his goods without making payment, although it is the other party's liability which is in issue.<sup>112</sup> Alternatively, both parties may be liable, but the creditor is only secondarily liable.<sup>113</sup>

Several distinct scenarios may arise. Where all that has occurred is legal compulsion, then it is most likely that the creditor will have a personal remedy. Where personal relief is sought, a creditor who is secondarily liable has the opportunity to reclaim funds from the defendant who is primarily liable.

Alternatively, if the defendant is insolvent and it is simply a question of legal compulsion, then it is strongly arguable that the creditor should be able to obtain a proprietary remedy against the insolvent. It cannot be said that the creditor has assumed the risk of the defendant's insolvency. Instead, the creditor has been placed in an invidious position in which he can only access his own goods through payment of the insolvent's liabilities. In contrast, when the creditor is secondarily liable, it is unlikely he is able to seek proprietary relief. The creditor was liable and in agreeing to such liability, he assumed the risk that at some stage the insolvent would be unable to pay.<sup>114</sup>

Finally, there are situations where the legal compulsion is combined with another vitiating factor such as overpayment.<sup>115</sup> In this case, the payee will be

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<sup>111</sup> *Brook's Wharf and Bull Wharf Ltd v Goodman Brothers* [1937] 1 KB 534; cf the facts in *Esso Petroleum Ltd v Hall Russell & Co Ltd* [1989] 1 AC 643.

<sup>112</sup> *Brook's Wharf and Bull Wharf v Goodman Brothers* [1937] 1 KB 534; *Exall v Partridge* (1799) 8 TR 308; 101 ER 1405; *Johnson v Royal Mail Steam Packet Company* (1867) LR 3 CP 38.

<sup>113</sup> *Moule v Garrett* (1872) LR 7 Ex 101; *Brooks Wharf and Bull Wharf Ltd v Goodman Brothers* [1937] 1 KB 534; *Gebhardt v Saunders* [1892] 2 QB 452; *Harris v Carnegie* [1933] OR 844.

<sup>114</sup> Note also the cases in relation to contribution *Lowe & Sons v Dixon & Sons* (1885) 16 QBD 455; *Ellesmere Brewery Co v Cooper* [1896] 1 QB 75; *Mahoney v McManus* (1981) 55 ALJR 673; *Newberry v Harrop* [1986] 1 Qd R 187.

<sup>115</sup> As to mistaken overpayments see below 262-263; 267-271.

required to repay an amount equivalent to the funds which have been overpaid. If the payee is insolvent, there is case law which suggests that an overpayment can give rise to proprietary relief.<sup>116</sup>

### ***3 Passive Exploitation of Vulnerability***

The passive exploitation of vulnerability is a more subtle method of advantage taking. It involves situations where a court ought to impose a duty of disclosure on the defendant, notwithstanding the fact that the transaction is a commercial one. The discussion commences with a consideration of unilateral mistake. Thereafter, undue influence and unconscionable transactions (particularly in the light of the duty of disclosure) and the problem of commercial information asymmetry are considered.

#### ***(a) Unilateral Mistake***

Unilateral mistake occurs where one party is aware of the mistake which another has made when entering the transaction, particularly a contract, and this party does nothing to inform the other of the error. Instead, the party hopes to gain from the mistake by relying on the terms of the contract. In *Taylor v Johnson*<sup>117</sup> the purchaser of land was aware that the vendor of the land had made a fundamental error in relation to the sale price and did not alert the vendor to the error. The Court held that the vendor was entitled to rescission of the contract.<sup>118</sup> It is not necessary for a party to demonstrate that the other deliberately set out to ensure that the other remains mistaken.<sup>119</sup> However, it has been held that the doctrine of unilateral mistake

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<sup>116</sup> *Chase Manhattan Bank NA v Israel-British Bank (London) Ltd* [1981] Ch 105; *Phoenix Assurance Co of Canada v City of Toronto* (1981) 129 DLR (3d) 351; (1982) 35 OR (2d) 16 (Montgomery J); 142 DLR (3d) 767, 39 OR (2d) 680 (CA); *Zaidan Group Ltd v City of London* (1987) 36 DLR (4th) 443; 58 OR (2d) 667 (Barr J); affd 49 DLR (4th) 681; 64 OR (2d) 438 (CA).

<sup>117</sup> (1983) 151 CLR 422.

<sup>118</sup> Ibid 432-433 (Mason ACJ, Murphy and Deane JJ). Other cases applying or considering the doctrine include *Deputy Commissioner of Taxation v Chamberlain* (1990) 26 FCR 221, on appeal (1991) 28 FCR 21; *Cielo v MG Kailis Gulf Fisheries Pty Ltd* (1991) 104 FLR 189, 192 (Gray J); *Roach v B & W Steel Pty Ltd* (1991) 23 NSWLR 110; *Lewis v Combell Constructions Pty Ltd* (1989) 18 NSWLR 528; *Tutt v Doyle* (1997) 42 NSWLR 10.

<sup>119</sup> See for example *Roach v B & W Steel Pty Ltd* (1991) 23 NSWLR 110, 114 (CA); *Lowe v Harrington* (1997) 138 FLR 1; (1996-1997) 21 Fam LR 583; *Tutt v Doyle* (1997) 42 NSWLR 10, 14 (CA).

will apply where a party was not actually aware of the mistake, but it 'was of such character and accompanied by such circumstances that he had reason to know of it'<sup>120</sup> or that he ought to have known of it.<sup>121</sup>

The traditional remedial response to unilateral mistake is rescission, a personal remedy. However, courts will award other remedies when the circumstances so require.<sup>122</sup> Therefore, where unilateral mistake is proven, proprietary relief should be available because the mistaken party has not assumed the risk of the commercial transaction.

### ***(b) Presumed Undue Influence***

Equity has also developed an effective doctrine to deal with those situations where there has been a relationship of trust and confidence giving courts cause to presume undue influence.<sup>123</sup> There are certain relationships of trust and confidence to which equity will raise an automatic presumption of influence such as parent and child, guardian and ward, religious leader and adherent, solicitor and client and doctor and patient.<sup>124</sup> The other form of presumed undue influence is where there is a relationship of trust and confidence.<sup>125</sup> However, undue influence has also been effectively extended to cases where an agent of a third party unduly influences

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<sup>120</sup> Arthur Linton Corbin, *Corbin on Contracts: A Comprehensive Treatise on the Rules of Contract Law* (1960) vol 3, § 610 cited with apparent approval by Mason ACJ, Murphy and Deane JJ in *Taylor v Johnson* (1983) 151 CLR 422, 432.

<sup>121</sup> *Roach v B & W Steel Pty Ltd* (1991) 23 NSWLR 110, 114 (CA); *Lewis v Combell Constructions Pty Ltd* (1989) 18 NSWLR 528, 536 (Finlay J); *Tutt v Doyle* [1997] 43 NSWLR 10, 14-15 (CA).

<sup>122</sup> *Tutt v Doyle* [1997] 42 NSWLR 10.

<sup>123</sup> Duggan, above n 103, [1111]-[1115] and the cases considered therein; Sheridan, above n 59, 88-96; Meagher, Gummow and Lehane, above n 69, [1511]-[1519].

<sup>124</sup> Duggan, above n 103, [1112]; Sheridan, above n 59, 90-96; Meagher, Gummow and Lehane, above n 69, [1511]-[1519].

<sup>125</sup> *Barclays Bank plc v O'Brien* [1994] 1 AC 180, 189-190 (Lord Browne-Wilkinson).

another<sup>126</sup> or the third party has actual or constructive notice that there has been undue influence.<sup>127</sup>

Undue influence has been allied to fiduciary obligations. Whilst it has been argued that the doctrines are distinct,<sup>128</sup> (so that for example, the parent-child relationship attracts an automatic presumption of undue influence, but it is not a fiduciary one), there have been strong arguments that they have much in common.<sup>129</sup> Both are concerned with relationships of trust and confidence the abuse of which are remedied by disgorgement.<sup>130</sup> Thus, undue influence could have been appropriately discussed in Chapter 2.

However, a discussion of undue influence is equally appropriate in this chapter as well and possibly more so. They are still separate doctrines in which the different aspects of relationships of trust and confidence are protected. They also have different historical origins.<sup>131</sup> The law of fiduciary obligations is driven by prophylactic rules ensuring that a fiduciary does not undertake transactions which conflict with that duty or enable him or her to obtain unauthorised profits from that duty. The doctrine of undue influence is not elevated to the status of a duty. Rather, it is used to set aside transactions which are acquired by the exercise of influence or pressure.

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<sup>126</sup> *Avon Finance Co Ltd v Bridger* [1985] 2 All ER 281; *Coldunell v Gallon* [1986] 1 QB 1184; *Bank of Credit & Commerce International SA v Aboody* [1990] 1 QB 923; *Challenge Bank Ltd v Pandya* (1993) 60 SASR 330.

<sup>127</sup> *Barclays Bank plc v O'Brien* [1994] 1 AC 180; *Challenge Bank Ltd v Pandya* (1993) 60 SASR 300, 343 (King CJ); cf recent developments in Australia in relation to married women in *Garcia v National Australia Bank Ltd* (1998) 155 ALR 614.

<sup>128</sup> Meagher, Gummow and Lehane, above n 69, [1520]; cf Goff and Jones, above n 90, 286.

<sup>129</sup> *Johnson v Buttress* (1936) 56 CLR 113, 135 (Dixon J).

<sup>130</sup> Duggan, above n 103, [1130].

<sup>131</sup> In relation to undue influence see *Earl of Chesterfield v Janssen* (1751) 2 Ves Sen 124, 156 28 ER 82, 100 (Lord Hardwicke) and *Earl of Aylesford v Morris* (1873) 8 Ch App 484, 489-490 (Lord Selborne). In relation to fiduciary obligations see LS Sealy in 'Fiduciary Relationships' [1962] *The Cambridge Law Journal*, 69, 69-72 and PD Finn, *Fiduciary Obligations* (1977) [2].



The exercise of influence has an obvious connection with the common law doctrine of duress. But presumed undue influence is concerned with the prevention of

taking surreptitious advantage of the weakness or necessity of another: which knowingly to do is equally against conscience as to take advantage of his ignorance.<sup>132</sup>

The court may require evidence of such matters as the intelligence, education, character, age, state of health and business experience of the aggrieved party.<sup>133</sup> Such factors will be important in setting up the relationship of the parties and the potential for abuse. The other factor is whether the party received independent advice – a common defence to all forms of undue influence.<sup>134</sup> Such advice must be given in a free and relaxed manner away from any potential pressure.<sup>135</sup> Otherwise, as recent case law has confirmed,<sup>136</sup> the absence of such independent advice will tend to the conclusion that the aggrieved party did not exercise an independent and fully informed intention to enter into the transaction. Therefore, proprietary relief ought to be available.<sup>137</sup>

Generally, rescission is the appropriate remedy. However, it is strongly arguable that a creditor seeking proprietary relief on the basis of undue influence did not assume the risk of the transaction. Undue influence implies an abuse of a relationship of trust and confidence by the insolvent. Following from this, the abuse is manifested in the lack of any credible independent advice to explain the ramifications of the transaction.<sup>138</sup> Moreover, proprietary remedies are available

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<sup>132</sup> *Earl of Chesterfield v Janssen* (1751) 2 Ves Sen 124; 156; 28 ER 82, 100 (Lord Hardwicke).

<sup>133</sup> See generally *Union Fidelity Trustee Co of Australia Ltd v Gibson* [1971] VR 573, 577-578 (Gillard J).

<sup>134</sup> Duggan, above n 103, [1119], [1121]; *Brusewitz v Brown* [1923] NZLR 1106, 1115-1117 (Salmond J).

<sup>135</sup> cf *Bank of Credit & Commerce International SA v Aboody* [1990] 1 QB 923.

<sup>136</sup> *Barclays Bank plc v O'Brien* [1994] 1 AC 180, 195-199 (Lord Browne-Wilkinson).

<sup>137</sup> Goff and Jones, above n 90, 286.

<sup>138</sup> For a discussion of undue influence and proprietary relief in the form of a constructive trust see Oakley, above n 63, 35-46.

where there has been a breach of fiduciary obligations.<sup>139</sup> The only major exception is that the proprietary scope of fiduciary obligations is wider (in the sense that the fiduciary proprietary net will catch gains obtained via breach of duty which the fiduciary himself could not have gained).<sup>140</sup>

### **(c) Unconscionable Dealing**

Equity will intervene where the insolvent has taken unconscientious advantage or exploitation of the vulnerability of the creditor (even though there is no pre-existing relationship of trust or confidence).<sup>141</sup> A successful creditor is required to prove that there was a special disadvantage like poverty, illness, age, infirmity, lack of education or lack of explanation of the transaction.<sup>142</sup> In addition, the defendant must have knowledge of the special disadvantage<sup>143</sup> and unconscientiously exploited that disadvantage.<sup>144</sup> An important expansion has been that a lack of business experience will also constitute a special disadvantage,<sup>145</sup> particularly in the context of standard form contracts.<sup>146</sup> Unconscionable dealing has taken two forms.

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<sup>139</sup> Chapter 2, 63-71.

<sup>140</sup> *Attorney-General (Hong Kong) v Reid* [1994] 1 AC 324.

<sup>141</sup> For an authoritative discussion of unconscientious dealings see the seminal case, *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447.

<sup>142</sup> *Blomley v Ryan* (1956) 99 CLR 362; *Wilton v Farnworth* (1948) 76 CLR 646; *Louth v Diprose* (1992) 175 CLR 621; *Vital Finance Corporation Pty Ltd v Taylor* (1991) ASC 56-099; *Morlend Finance Corp (Vic) Pty Ltd v Luke* (1991) ASC 56-095.

<sup>143</sup> *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447; *Hart v O'Connor* [1985] AC 1000; *Morlend Finance Corp (Vic) Pty Ltd v Luke* (1991) ASC 56-095; cf *Melverton v Commonwealth Development Bank of Australia* (1989) ASC 55-921.

<sup>144</sup> *Ibid.*

<sup>145</sup> *Morlend Finance Corp (Vic) Pty Ltd v Luke* (1991) ASC ¶ 56-095.

<sup>146</sup> *A Schroeder Music Publishing Co Ltd v Macaulay* [1974] 1 WLR 1308, 1314-1315, [(Lord Reid); 1315-1314 (Lord Diplock); *Clifford Davis Management Ltd v WEA Records Ltd* [1975] 1 WLR 61, 64-65 (Lord Denning MR); *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447.

### ***(i) Special Disadvantage - Innate Disadvantage***

There is the possibility of intervention where the insolvent acquiring a benefit has knowledge of the special innate disadvantage of the creditor. In *Re Walsh; Ex parte Waters*<sup>147</sup> an undischarged bankrupt described by the court as a 'confidence man',<sup>148</sup> placed advertisements in newspapers in which he solicited investments in businesses holding out that there would be high returns. The applicant, a retired engine driver, replied to the advertisements and agreed to invest in a mining company. A few days later the applicant was informed by the police that he had been defrauded. He claimed in bankruptcy proceedings that the funds paid only for the purpose of acquiring mining shares and that the Official Receiver in Bankruptcy held those funds on trust for the applicant. Stable J agreed with this argument.<sup>149</sup> However, it is clear that Stable J was also influenced by the relative abilities of the parties as well. He described the applicant as:

a trusting, foolish elderly man [who] was taken in by a newspaper advertisement which would not have drawn more than a raised eyebrow from a more worldly reader.<sup>150</sup>

The facts also fell within the criteria for unconscionable transactions. The simple and trusting elderly engine driver had a special disadvantage of age and limited education which the trickster exploited. In the light of the special disadvantage, it could be said that the applicant did not, objectively speaking, assume the risk of the transaction.

### ***(ii) Non-Disclosure of Important Information Concerning the Financial State of the Defendant***

Courts have held that an insolvent was not entitled to retain funds which had been obtained in the context of a parlous financial situation which was known to the

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<sup>147</sup> [1978] Qd R 134.

<sup>148</sup> Ibid 135.

<sup>149</sup> But note the analysis in Chapter 3, 112-114.

<sup>150</sup> [1978] Qd R 134, 135.

insolvent or in the case of a company, the officers of the company. In other areas of law, legislatures have frowned on trading after insolvency.<sup>151</sup>

Such situations fit within the equitable doctrine of unconscientious dealing because the creditor suffers from a special disadvantage which is a form of information asymmetry.<sup>152</sup> The insolvent takes advantage of this information asymmetry and receives a benefit, knowing that it is insolvent or that the financial situation is very dire.

The proposition that in certain situations an information asymmetry must be remedied, may appear somewhat inconsistent and antithetical to the law on fraudulent<sup>153</sup> and innocent misrepresentations.<sup>154</sup> A fundamental tenet of the law is that simple silence is not actionable and a positive representation is required to activate the law relating to misrepresentations.<sup>155</sup> The definition of positive statements is wide.<sup>156</sup> In contrast, equity intervenes on the basis that there was a duty to disclose information. It appears that a failure to disclose will invite equitable intervention.<sup>157</sup> So that, whilst the silence of the insolvent about its parlous financial status is not actionable on the basis of the misrepresentation, equity does require disclosure of information where there is an evident information asymmetry. Without a readjustment of the information asymmetry, a party could act against his interest without being fully informed of the commercial consequences of the transaction. Such a party could rightly state that the reason for his non-assumption of the risk was the insolvent's failure to disclose vital information which led him not to take any or sufficient action to minimise risk. Therefore, the appropriate redress for information

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<sup>151</sup> See for example the *Corporations Law* (Cth) Part 5.7B, Divisions 3 and 4.

<sup>152</sup> For a brief discussion of the different definitions of information asymmetry in the context of market regulation see *Financial System Inquiry Final Report* (1997) 190.

<sup>153</sup> See above, 234-235

<sup>154</sup> See below, 264-266.

<sup>155</sup> *Smith v Hughes* (1871) LR 6 QB 597; *W Scott, Fell & Co Ltd v FH Lloyd* (1906) 4 CLR 572. In relation to exceptions to the rule: see Duggan, above n 69, [611].

<sup>156</sup> *Walters v Morgan* (1861) 3 De GF & J 718, 723-724; 45 ER 1056, 1059 (Lord Campbell LC).

<sup>157</sup> See for example the recent decision of the High Court of Australia in *Garcia v National Australia Bank Ltd* (1998) 155 ALR 614.

asymmetry is disclosure of the relevant commercial information where that information is not publicly available. This general countermeasure to information asymmetry has been operational in our legal system as the concept of *uberrima fides* shows.<sup>158</sup>

An analysis of the *Commercial Bank of Australia Ltd v Amadio*,<sup>159</sup> indicates that disclosure lies at the heart of the equitable doctrine of unconscionable dealing. In that case, elderly parents executed a mortgage over the home in order to secure an overdraft facility made available to a company controlled by the son. The parents were immigrants whose understanding of the English language was limited. The parents were unaware of both the company's and the son's precarious financial situation. Moreover, the son misled the parents about the nature and extent of the mortgage. The parents believed that the mortgage secured \$50,000 for 6 months. In fact, the mortgage was an unlimited security. It is most likely that the parents would not have signed the documentation if the company's financial situation and nature of the mortgage had been disclosed by an independent third party. However, caution is needed where independent advice is involved. Where the defendant is insolvent (or close to insolvency) independent advice may not be an adequate defence. The independent advice may be naively predicated on solvency or a buoyant financial condition. Both the independent adviser and the creditor may be entitled to assume that the defendant is solvent and the transaction, in the light of that assumption, may appear prudent.

The cases can be conveniently divided into two strands. There are those situations where an insolvent receives funds when it is already insolvent and fails to disclose the insolvency. An alternative situation is where the insolvent receives funds when it is in a parlous financial situation, fails to disclose this and becomes insolvent.

### ***Insolvency***

The intervention of equity and the imposition of proprietary relief in cases of receiving funds whilst insolvent was presaged by courts utilising the swollen assets

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<sup>158</sup> Chapter 1, 24-26.

<sup>159</sup> (1983) 151 CLR 447.

theory in the United States particularly during the Depression <sup>160</sup> and they will not be further discussed here.

*Neste Oy v Lloyd's Bank plc*<sup>161</sup> illustrates information asymmetry. Although the failure to disclose took place in the context of an ongoing relationship, the analysis will be the same for pre-transactional situations and ongoing relationships. The plaintiffs were ship owners. From time to time they employed Peckton Shipping Ltd ('PSL') as their agent in the United Kingdom. The plaintiffs paid moneys into PSL's account with Lloyds Bank plc for the payment of any cost incurred by the plaintiff's vessels during visits to the United Kingdom. Due to financial difficulties, the Peckton Group (including PSL) stopped trading. Lloyds sought to set off group debts against moneys paid by the plaintiffs into the PSL account. The plaintiffs brought an action claiming that Lloyd's was not entitled to a set-off and that PDL held the funds on trust.

Bingham J held that PSL could not retain the moneys received from the plaintiff after it had ceased trading.<sup>162</sup> The defendant's conduct was unconscionable because it had not disclosed its insolvency and inability to perform the contract. The insolvent and its unsecured creditors would obtain a windfall because more funds would be distributable.<sup>163</sup> Indeed, it could be said that to determine otherwise would permit an insolvent to retain funds in circumstances where the plaintiff could not be objectively expected to assume commercial risk, because the non-disclosure contributed to the plaintiff's unsecured status.

### ***Parlous Financial Situations***

Where a person or a firm is not insolvent, but is in a parlous financial situation, it may be more difficult to determine whether or not the court should intervene and provide proprietary relief. When they applied the swollen assets theory, some courts suggested that unless there was actual insolvency, courts should

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<sup>160</sup> For a discussion of these cases see Chapter 4, Part IV.

<sup>161</sup> [1983] 2 Lloyd's Rep 658.

<sup>162</sup> Ibid 666.

<sup>163</sup> Ibid.

not provide proprietary relief.<sup>164</sup> On the other hand, there were cases which illustrated that courts would be able to intervene if the person or firm were in such a parlous financial position that it was most unlikely that they would recover.<sup>165</sup> This approach appears to have currency today.<sup>166</sup> The question in each case amounts to whether the financial circumstances were so grim that they ought to have been disclosed to the creditor.

One factor which may dissuade a party from disclosing the parlous financial situation is that such disclosure may be construed as an act of bankruptcy. If a debtor notifies creditors that it has suspended or is about to suspend payment of debts, the debtor commits an act of bankruptcy.<sup>167</sup> Another factor would be that the release of such commercially sensitive information could cause a panic amongst creditors and worsen the prospects of the debtor (particularly if the creditors refuse to deal with the debtor or call in loans early).

On the other hand, failure to inform a potential creditor means that it is more likely that a creditor will be satisfied with its unsecured status without taking steps to protect itself against the potential insolvency, particularly where any investigation of public records fails to disclose the problem. Thus, where information concerning the parlous financial status of the defendant is not available and/or searching for such information is not market practice, the unsecured creditor should be elevated to the status of a secured creditor where there is a failure to disclose it. However, one essential qualification is that the insolvency should be imminent. The following material deals with various commercial transactions in which the failure to disclose an imminent collapse was a crucial aspect in the unsecured creditor's application for proprietary relief.

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<sup>164</sup> Chapter 4, 167-170.

<sup>165</sup> *Ibid.*

<sup>166</sup> *Re Bengal Trading Corporation* 12 Bankr 695 (Bankr SD Fla, 1981) and *Re Vermont Real Estate Investment Trust* 25 Bankr 813 (Bankr D Vt, 1982). See generally Jeffrey Davis, 'Equitable Liens and Constructive Trusts in Bankruptcy: Judicial Values and the Limits of Bankruptcy Distribution Policy' (1989) 41 *Florida Law Review* 1, 44-46.

<sup>167</sup> *Bankruptcy Act 1966* (Cth) s 40 (1) (h); *Re Hewson; Ex parte Sydney Stock Exchange Ltd* (1967) 10 FLR 479.

## *Transfer of Funds for Investment*

In *Daly v Sydney Stock Exchange Ltd* ('Daly'),<sup>168</sup> a customer of a stockbroking firm wished to invest in shares. An employee of the firm advised the customer that the investment in shares at the time was not wise. He suggested that the customer deposit funds with the firm in the form of a loan until it was commercially sound to purchase shares. The customer lent the money on loan on interest and subsequently added a further sum to the initial amount. Unknown to the employee of the firm, the firm was in a parlous financial situation. The partners were aware of the situation, but continued to operate commercially. The customer assigned the deposits to his wife. Three months after the customer had made the first deposit and one month after the customer had made the subsequent deposit, the firm ceased trading and became insolvent. The firm was unable to repay the deposit.<sup>169</sup> The plaintiff brought an action claiming that she was entitled to recover compensation.<sup>170</sup> She was unsuccessful before the Court of Appeal where it was held that compensation was available where there had been a defalcation within the meaning of the relevant legislation; and that a breach of fiduciary duty did not constitute such a defalcation.<sup>171</sup>

On appeal, the High Court held that the firm had breached its fiduciary duties to the customer because the firm had failed to disclose its own interest in the transaction, particularly its parlous financial position.<sup>172</sup> However, the Court held that the money which had been deposited with the firm was not the subject of a constructive trust. Relying on *Lister v Stubbs*,<sup>173</sup> characterising the dealing with the

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<sup>168</sup> (1986) 160 CLR 371.

<sup>169</sup> Ibid 375 (Gibbs CJ).

<sup>170</sup> *Securities Industry Act 1975* (NSW) s 97.

<sup>171</sup> [1982] 2 NSWLR 421, 427 (Reynolds JA).

<sup>172</sup> (1986) 160 CLR 371, 377 (Gibbs CJ with whom Wilson and Dawson JJ agreed); 385-386 (Brennan J).

<sup>173</sup> (1890) 45 Ch D 1.



money as a loan<sup>174</sup> and taking into account the interests of other unsecured creditors,<sup>175</sup> the Court held proprietary relief was not appropriate.<sup>176</sup>

It is submitted that, when appropriate, the High Court should reconsider its decision in *Daly*. First, *Lister v Stubbs*<sup>177</sup> has been recently overruled in *Attorney-General (Hong Kong) v Reid*.<sup>178</sup> The latter case has established that the imposition of proprietary relief in the form of a constructive trust was appropriate when a corrupt fiduciary obtained benefits from third parties during the course of the fiduciary relationship.

Secondly, although the firm was not corrupt like the defendant in *Attorney-General (Hong Kong) v Reid*, the firm had breached its fiduciary duty to its customer. In *Attorney-General (Hong Kong) v Reid*, the Privy Council examined the relationship between the breach of fiduciary duty and the acquisition of funds and property acquired. In *Daly*, the Court failed to follow through the fact that the breach of fiduciary duty was directly linked to the acquisition of the loan funds and for that reason the plaintiff was entitled to proprietary relief.<sup>179</sup> Recourse to a personal remedy afforded by the existence of a claim based on common law debt did nothing to ensure that the firm was not enriched by the firm's convenient failure to disclose. Instead, the firm benefited from that failure because there were additional funds available for the payment of liabilities which would certainly not have been available if there had been a disclosure. Whilst the majority of the Court was concerned that the money would have been withdrawn from the general body of unsecured creditors, it did not perceive that an obvious fault on the part of the firm had swelled the assets to which the general creditors were entitled. The reasoning and outcome of

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<sup>174</sup> (1986) 160 CLR 371, 377 (Gibbs CJ with whom Wilson and Dawson JJ agreed).

<sup>175</sup> *Ibid.*

<sup>176</sup> *Ibid* 379.

<sup>177</sup> (1890) 45 Ch D 1.

<sup>178</sup> [1994] 1 AC 324.

<sup>179</sup> See the comments in *Stephenson Nominees Pty Ltd v Official Receiver* (1987) 76 ALR 485, 506 (Gummow J); Barbara McDonald, 'Constructive Trusts' in Patrick Parkinson (ed) *Principles of Equity* (1996) [2120]; Malcolm Cope, 'Ownership, Obligation, Bribes and the Constructive Trust' in Malcolm Cope (ed), *Equity Issues and Trends* (1995) 91, 114.

the case did not adequately address the fact the plaintiff's unsecured status was directly linked to the failure to disclose.

Thirdly, even if the stockbroker had not owed a fiduciary duty to the customer, it would have been fitting for the Court to have granted the plaintiff proprietary relief. The firm had unconscionably failed to disclose its poor financial position. Thus, the customer had not assumed the risk of the imminent collapse of the firm.

Instead, the decisions in *Hill v Rose* ('*Hill*')<sup>180</sup> and *Lankshear v ANZ Banking Group (New Zealand) Ltd*<sup>181</sup> display a greater sensitivity to the issue of disclosure than the High Court in *Daly*.

In *Hill*, one of the defendants, a director of a company, invited the plaintiff to invest in a company. This defendant was described as 'the guiding spirit.'<sup>182</sup> He did not disclose to the plaintiff that the company had liabilities which were in excess of \$1.4 million and accumulated losses of over \$950,000<sup>183</sup> or that the company carried on the business as trustee of the family trust.<sup>184</sup> Tadgell J held that the defendants owed the plaintiff fiduciary obligations and non-disclosure amounted to breach of those obligations. Accordingly, the plaintiff was entitled to judgement against the company and judgement against the individual defendants for an indemnity for the amount not recovered from the company.

It is arguable that if the theory of objective non-assumption of risk was applied in the form articulated above, the plaintiff may not have succeeded. After all, the judge commented that the plaintiff was:

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<sup>180</sup> [1990] VR 129.

<sup>181</sup> [1993] 1 NZLR 481.

<sup>182</sup> [1990] VR 129, 130.

<sup>183</sup> *Ibid* 135-136.

<sup>184</sup> *Ibid* 135.

amazingly naive...and provided the money without receiving proper advice about, or carefully considering for himself...the consequences of his doing so.<sup>185</sup>

However, the case is distinguishable from the kinds of situations which have been discussed. The plaintiff sought and obtained a personal remedy in the form of equitable compensation. As the company was insolvent, the plaintiff was awarded an indemnity against the other defendants for those amounts which the company still owed. Therefore, Tadgell J did not have to focus on whether the unconscionable conduct led to the unsecured status of the plaintiff in determining whether to provide proprietary relief.

### ***Investment in a Partnership***

In *Lankshear v ANZ Banking Group (New Zealand) Ltd*,<sup>186</sup> the plaintiff formed a partnership and paid her co-partner, Broadley, \$80,000 for the partnership project. She obtained a third mortgage over Broadley's home for the amount contributed. The plaintiff had acquired the \$80,000 for investment by way of an overdraft from the National Bank which was secured over her family home. Broadley was adjudicated bankrupt and the plaintiff obtained judgment against him for the amount secured under the mortgage but was never repaid the contribution. The plaintiff was required to sell her own home in order to repay her own overdraft. The plaintiff sought personal relief against the bank..

There appears to have been two factors which persuaded the Court that the plaintiff was entitled to proprietary relief against Broadley.<sup>187</sup> There was a fiduciary relationship between the parties as partners in the business venture. Failure to disclose that the funds would be used to pay a pre-partnership overdraft amounted to a breach of duty. In addition, it appears that whether or not there was a breach of fiduciary obligations, the relationship was one which demanded that Broadley disclose how the funds were going to be used. On this basis, the plaintiff was also entitled to proprietary relief. Therefore, she was entitled to a constructive trust

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<sup>185</sup> Ibid 132.

<sup>186</sup> [1993] 1 NZLR 481.

<sup>187</sup> Ibid 490.

against Broadley. A large portion of the funds had been deposited in Broadley's bank account and the plaintiff was able to access it via the rule in *Barnes v Addy*.<sup>188</sup>

Analysing the case from the perspective of the assumption of risk, it is clear from the judgment that the plaintiff did not assume the risk of an unsecured creditor. As Wallace J stated, the plaintiff would not have provided the funds if she had realised that her partner was in financial difficulties.<sup>189</sup> Therefore, not only should Broadley have immediately disclosed how he intended to use the money, but also the general financial problems which beset him. These financial problems were extant between Broadley and a financial institution. It would have been impossible for the plaintiff to have obtained information of such a difficult commercial relationship because the bank would have been in breach of its duty to customers not to divulge such confidential information to third parties.<sup>190</sup>

Leaving aside arguments based on the rule in *Barnes v Addy*, without the availability of proprietary relief in the form of a constructive trust against Broadley, the plaintiff could have suffered severely from the improvident transaction. Even if the relationship had been characterised as fiduciary, the current equitable tracing rules would probably have been of little assistance as the funds were immediately dissipated in the black hole of a large overdraft.<sup>191</sup> In this case, it was necessary for the Court to impose proprietary relief in order to ensure that the defendant did not retain an advantage from the information asymmetry.

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<sup>188</sup> Ibid 494-496.

<sup>189</sup> Ibid, 490.

<sup>190</sup> In relation to confidential information see *Saltman Engineering Co Ltd v Campbell Engineering Co Ltd* (1948) 65 RPC 203; [1963] 3 All ER 413n; *Attorney-General v Guardian Newspapers (No 2)* [1990] 1 AC 109; *Attorney-General (UK) v Heinenmann Publishers Australia Pty Ltd* (1987) 10 NSWLR 86. In relation to a bank's duty of confidentiality and exceptions see Ross Cranston, *Principles of Banking Law* (1997) Chapter 6; Ellinger and Lomnicka, above n 38, 133-143; GA Weaver and CR Craigie, *The Law Relating to Banker and Customer in Australia* (2<sup>nd</sup> ed, 1990-) vol 1, [6.590].

<sup>191</sup> *Bishopsgate Investment Management Ltd (in liq) v Homan* [1995] Ch 211.

## *Receipt of Property for Sale as Agent*

In *Westpac Banking Corporation v Savin*,<sup>192</sup> Aqua Marine was appointed as agent to sell the two respondent's boats in September and October 1978 and failed to disclose its parlous financial situation. Both vessels were sold respectively in September and October. In both cases, Aqua Marine deposited the sale proceeds into an overdrawn general account. Neither vendor was paid any of the sale proceeds. Aqua Marine went into liquidation in November 1978 and there were no funds to meet its liabilities to unsecured creditors.

At first instance,<sup>193</sup> Holland J viewed the actions of Aqua Marine dimly. He held that the Aqua Marine was in breach of its fiduciary obligations to the vendors. He said that the nature of the transactions indicated that the vendors impliedly authorised the deposit of the sale proceeds into the Aqua Marine's general account. However, the principals had not authorised the company to use the sale proceeds for the company's own purposes. Therefore, the owners retained a proprietary interest in the sale proceeds.<sup>194</sup>

In the light of the discussion concerning the fungibility and negotiability of money<sup>195</sup> and the way that proceeds of sale are generally treated in the hands of agents,<sup>196</sup> it was probably incorrect to automatically characterise the sale proceeds as the property of the vendors. There was no requirement to segregate the money. Indeed, there was an implied authorisation to deposit sale proceeds into the general account. Such an authorisation carries with it the implication that the agent may use the money as its own. Even though an agency relationship is fiduciary,<sup>197</sup> it cannot be assumed that the principal has an automatic proprietary interest in the sale proceeds. There is old authority which suggests that where there is a single, one-off transaction, the principal is entitled to assume that the agent holds the proceeds of

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<sup>192</sup> [1985] 2 NZLR 41.

<sup>193</sup> *Savin & Boyle v De Vere* (1983) 1 BCR 545.

<sup>194</sup> *Ibid* 549.

<sup>195</sup> Chapter 1, 11-13.

<sup>196</sup> Chapter 2, 62-63.

<sup>197</sup> See for example, *Walker v Corboy* (1990) 19 NSWLR 382.

sale as a trustee<sup>198</sup> and is able to use equitable tracing in order to access the funds.<sup>199</sup> Thus, here it is arguable that the fiduciary aspect of the agency relationship invested the vendors with a proprietary interest in the sale proceeds. However, even if this had been the case, the exercise of proprietary rights pursuant to the fiduciary relationship, would not assist because the funds had been dissipated into the black hole of the overdrawn account. Traditional equitable tracing rules would not assist in the recovery of dissipated funds.<sup>200</sup>

A majority of the New Zealand Court of Appeal accepted that there had been a breach of fiduciary duty and that the vendors had implicitly authorised the deposit of the funds into an account.<sup>201</sup> They recognised that the vendors would not have permitted the agent to dissipate their funds in the overdrawn account if there had been full financial disclosure. It is likely that the vendors would have taken steps to protect their proprietary interest in the funds or obtained the services of another agent.<sup>202</sup> McMullen J held that there was no authorisation for the deposit of the funds in the company's account.<sup>203</sup> However, for the reasons already stated, this is not a helpful method of analysis.

Another way of dealing with the matter would have been to consider whether the vendors assumed the risk of the agent's imminent insolvency. The problem did not lie in the fact that the sale proceeds did not belong to the company and that the company was using the proceeds for its own purposes. An evaluation of the facts showed that, an implied authorisation to deposit in a general account was already an authorisation to an agent to use the funds as its own (with the proviso that an equivalent amount to the sale proceeds would, in due course, be forwarded to the

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<sup>198</sup> *Foley v Hill* (1848) 2 HL Cas 28, 35-36; 9 ER 1002, 1005; *Palette Shoes Pty Ltd (In Liq) v Krohn* (1937) 58 CLR 1, 30 (Dixon J). See also *Walker v Corboy* (1990) 19 NSWLR 382, 383-384 (Priestley JA).

<sup>199</sup> *Lupton v White* (1808) 15 Ves 432; 2 Ves Jun Supp 416; 33 ER 817; 34 ER 1158 and *Re Hallett's Estate, Knatchbull v Hallett* (1880) Ch D 696, 719 (Jessel MR).

<sup>200</sup> See the discussion of traditional tracing rules in equity in Chapter 2 above, 67-71 and *Bishopsgate Investment Management Ltd (in liq) v Homan* [1995] Ch 211.

<sup>201</sup> [1985] 2 NZLR 41, 45 (Richardson J with whom Sir Clifford Richmond agreed).

<sup>202</sup> *Ibid.*

<sup>203</sup> *Ibid* 55 (McMullen J).

vendors). Indeed, as some evidence indicated, there was nothing unusual in agents depositing sale proceeds into general accounts.<sup>204</sup> Rather, the problem was that the vendors had not been alerted to the general parlous state of the agent's affairs and the account was overdrawn. This was the basis upon which the vendors could have argued that they were entitled to proprietary relief. As it turned out, the vendors were able to obtain personal relief against the agent's bank under the rule of *Barnes v Addy*.<sup>205</sup> But here it appears that the wrongdoing was not sheeted home to the major wrongdoer, but to a bank which was deemed to have constructive notice of the nature of the funds deposited in the account.<sup>206</sup>

### ***Mail Order Purchases***

In the light of the concerns of the courts that the transferors and principals should not be vulnerable to information asymmetry, the English decision in *Re Kayford Ltd (in liq)*<sup>207</sup> becomes clear. Kayford Ltd was a mail order company. Customers paid either the full purchase price or a deposit for the goods. The company found it increasingly difficult to obtain supplies for the goods and was concerned that these difficulties would affect its financial viability. The company consulted its accountants who advised it to deposit the mail order funds into a separate account to ensure that if the company went into liquidation, the funds could be refunded to prepaying customers. The company placed the funds into a separate account. Megarry J held that the unilateral intention on the part of Kayford Ltd was sufficient to create an express trust.<sup>208</sup> The nature of the customers and the potential liquidation of the company demanded that the company act honourably and protect customers by utilising the trust as a security device.<sup>209</sup> What Megarry J located was the need for transferees or agents to act openly and honestly with those parties with

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<sup>204</sup> Ibid 45-46 (Richardson J with whom Sir Clifford Richmond agreed).

<sup>205</sup> (1874) LR 9 Ch App 244.

<sup>206</sup> Ibid 50-54 (Richardson J); 61-71 (Sir Clifford Richmond).

<sup>207</sup> [1975] 1 WLR 279.

<sup>208</sup> Ibid, 281-282.

<sup>209</sup> Ibid 202. Compare the judicial attitude to trade debtors in *Re Ayoub; ex parte Silvia* (1983) 67 FLR 144, 149 (Morling J).

whom they do business. Therefore, they had to either disclose business difficulties or to take effective steps to ensure that the customers (and presumably principals) obtained security over the funds pending the finalisation of the transaction. Otherwise, the transferee (or agent) and its other unsecured creditors will have the benefit of the information asymmetry. It is not surprising that at the end of his judgment,<sup>210</sup> Megarry J spoke so approvingly of the actions which had been taken by officers of Kayford Ltd. In the light of the theory of objective non-assumption of risk, if the company had not acted as it had, the customers could have sought the imposition of proprietary relief.

The preceding discussion indicates that the concept of information asymmetry will broaden in the light of the practical constraints which are associated with information gathering and the assumption of risk. The courts did not suggest that the parties were under a conventional special disadvantage or that these plaintiffs were naive about the nature of commercial transactions.<sup>211</sup> Rather, these plaintiffs were at an evident disadvantage because of information asymmetry. If the plaintiffs had been made aware of the parlous financial situation, it is unlikely that they would have entered the transactions in the first place.

## ***C Unconscionable Conduct After the Commercial Transaction Commenced***

### ***1 Introduction***

The preceding discussion addressed unconscionable conduct which occurred prior to the commencement of the transaction. However, insolvents may also act unconscionably during the course of a commercial transaction where the insolvent has received money (or goods for sale) from the plaintiff. The plaintiff intended the transfer of the funds (or goods for sale). Therefore, the plaintiff's capacity to act independently and/or in an informed way was not impaired prior to the transaction. The assumption under which the plaintiff operated was not induced by the insolvent (with the exception of innocent misrepresentation). However, the insolvent subsequently acts unconscionably when it refuses to restore the plaintiff to the

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<sup>210</sup> Ibid.

<sup>211</sup> For an example of a situation of parties who evidently had little or no business experience see: *Morlend Finance Corp (Vic) Pty Ltd v Luke* (1991) ASC ¶56-095.



situation prior to the acquisition of the benefit. Equity will not permit the party to retain that benefit. There are two major permutations of this theme.

First, there are those situations discussed below under the heading, 'Subsequent Unconscionable Conduct.' These are cases where the transaction has 'commenced, but the transaction is not completed due to an intervening discovery or vitiating factor. Such a discovery or vitiating factor totally changes the legal and the commercial matrix to the extent that it is no longer effective. Thereafter, the recipient of the money becomes insolvent. The breakdown of the commercial venture leads to the retention of a benefit which was not contemplated without its successful completion. In some circumstances, the commercially honourable course would be for each party to restore the other to the situation before the transaction commenced (subject to a plaintiff's right to affirm voidable contracts), taking into account costs and liabilities incurred by each of the parties - a kind of practical justice approach as adopted by equity in rescission cases.<sup>212</sup> However, the insolvent may refuse to disgorge the money or the monetary equivalent. The insolvent's reaction to the vitiating factor and the retention of the funds is the unconscionable conduct which triggers equitable intervention.<sup>213</sup> So, plaintiffs have had to bring an action to have the money (or its equivalent) disgorged from the assets of the insolvent.

The topic of ineffective contracts is a large one. The general rubric can cover contracts which are void *ab initio*<sup>214</sup> voidable contracts,<sup>215</sup> contracts which are anticipated<sup>216</sup> and contracts which are discharged by breach.<sup>217</sup> Some authors also include illegal contracts as comprising part of the notion of void and ineffective

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<sup>212</sup> Louis Proksch, 'Rescission' in Patrick Parkinson (ed), *The Principles of Equity* (1996) 856 [2510]-[2511].

<sup>213</sup> See the discussion of *Muschinski v Dodds* (1985) 160 CLR 583 in Chapter 5, 195-199.

<sup>214</sup> *Craven-Ellis v Canons Ltd* [1936] 2 KB 403; *Guinness plc v Saunders* [1990] 2 AC 663, *Rover International Ltd v Cannon Film Sales Ltd* [1990] 1 WLR 912. In relation to a company or a local authority acting ultra vires see *Sinclair v Brougham* [1914] AC 398; *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 699.

<sup>215</sup> *Redgrave v Hurd* (1881) 20 Ch D 1.

<sup>216</sup> *Way v Latilla* [1937] 3 All ER 759; *William Lacey (Hounslow) Ltd v Davis* [1957] 1 WLR 932; *British Steel Corporation v Cleveland Bridge and Engineering Co Ltd* [1984] 1 All ER 504.

<sup>217</sup> See for example, *Rowland v Divall* [1923] 2 KB 500. Note Goff and Jones, above n 90, 412-447; Andrew Burrows, *The Law of Restitution* (1993) 261-281.

contracts.<sup>218</sup> However, for the purpose of this discussion supervening illegality is considered in the context of defences in Chapter 7.<sup>219</sup> Some authors have suggested that, in principle, a party faced with an ineffective contract should not have access to proprietary relief.<sup>220</sup> Others have suggested that proprietary relief is available (even to a limited extent).<sup>221</sup> In the light of the different factual situations which may arise in relation to ineffective contracts, it is unlikely that it can be said unequivocally that proprietary relief is always an appropriate response. Ultimately, the question will be whether the plaintiff, in the context of the ineffective contract, has assumed the risk of an unsecured creditor.

Secondly, there are those situations discussed under the heading 'Mutual Omissions.' Here, it has not been the unconscionable conduct of the insolvent which induced the plaintiff to enter the transaction. These are cases where an event triggers the need for equitable intervention even though the event may not bring the ongoing relationship to an end. Sometimes it is the insolvency of the transferee or the agent which does so. The plaintiff may have initially assumed the risk of an unsecured creditor, but the problem is that the parties have not negotiated what should happen to the funds or the proceeds of sale on the occurrence of the triggering event.

## ***2 Subsequent Unconscionable Conduct***

### ***(a) Innocent Misrepresentation***

An innocent misrepresentation renders contracts voidable.<sup>222</sup> Although the original innocent misrepresentation may be an act of the insolvent, it is not the product of unconscientious motivations. Therefore, it would be the insolvent's response to the discovery of the innocent misrepresentation and the refusal to repay

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<sup>218</sup> See Goff and Jones, above n 90, 498.

<sup>219</sup> Chapter 7, 325-329.

<sup>220</sup> Goff and Jones, above n 90, 94.

<sup>221</sup> Sarah Worthington, *Proprietary Interests in Commercial Transactions* (1996) 157- 165; Peter BH Birks, 'Restitution and Resulting Trusts' in Stephen Goldstein (ed), *Equity and Contemporary Developments* (1992) 335.

<sup>222</sup> Greig and Davis, above n 75, 826; KE Lindgren, JW Carter and DJ Harland, *Contract Law in Australia* (3<sup>rd</sup> ed, 1996) [1002].

the benefit accrued (rather than the innocent misrepresentation) which would constitute unconscionable conduct. Traditionally, the remedies for innocent misrepresentation at common law were very narrow.<sup>223</sup> Equity created a jurisdiction which went beyond common law because equity provided relief for a misrepresentation without the need for the proof of fraud in the strict sense.<sup>224</sup> Equity may refuse to grant specific performance to the representor or may grant the remedy of rescission of the contract to the representee.<sup>225</sup>

The leading case is the 19th century decision, *Redgrave v Hurd* which did not deal with insolvency.<sup>226</sup> A vendor selling a house and legal practice, innocently misrepresented the amount of income which was derived from operating the business. The vendor sought specific performance and the purchaser sought rescission of the contract. At first instance, Fry J held that the vendor was entitled to specific performance on the basis that the purchaser should have taken care to investigate the representations.<sup>227</sup> This view is generally consistent with the doctrine of caveat emptor,<sup>228</sup> in the sense that purchasers should take care to investigate for themselves the substance of representations made by a vendor. On appeal, Sir George Jessel highlighted equity's broad jurisdiction and said:

It was put in two ways, either of which was sufficient. One way of putting the case was, 'A man is not to be allowed to get a benefit from a statement which he now admits to be false. He is not to be allowed to say, for the purpose of civil jurisdiction, that when he made it he did not know it to be false; he ought to have found that out before he made it.' The other way of putting it was this: Even assuming that moral fraud must be shewn in order to set aside a contract, you have it where a man, having obtained a beneficial contract by a statement which he now knows to be false, insists upon keeping that contract. To do so is a moral delinquency: no man ought to seek to take advantage of his own false statements.' The rule in equity was settled,

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<sup>223</sup> Duggan, above n 69, [602]-[603].

<sup>224</sup> *Redgrave v Hurd* (1881) 20 Ch D 1.

<sup>225</sup> Duggan, above n 69, [603].

<sup>226</sup> (1881) 20 Ch D 1.

<sup>227</sup> *Ibid* 8.

<sup>228</sup> Chapter 1, 17.

and it does not matter on which of the two grounds it was rested....If a man is induced to enter into a contract by a false representation it is not a sufficient answer to him to say, 'If you had used due diligence you would have found out that the statement was untrue. You had the means afforded you of discovering its falsity, and did not choose to avail yourself of them.'<sup>229</sup>

The vendor's response to the discovery of the innocent misrepresentation was unconscionable.

In one major respect the approach of Jessel MR differs from the concept of objective non-assumption of risk. He created an essentially strict liability regime. The representor was not entitled to specific performance and the representee was almost automatically entitled to rescission. Today, courts should take a more balanced approach, particularly where the representor was insolvent. Courts should not simply absolve the representee from any responsibility to investigate the truth of the representation. Factors such as the public availability of the information (which formed the substance of the representation), the costs of investigating the truth of such financial information in the light of the full market value of the transaction<sup>230</sup> and market practice would also be highly relevant. In *Redgrave v Hurd* the vendor did not keep good records of account and this may have ultimately been in the purchaser's favour. However, today a purchaser would be entitled to insist upon a thorough investigation of detailed and audited books of account before entering into the contract of sale. Certainly, the purchaser would be well advised to do so.<sup>231</sup>

### ***(b) Common Mistake***

The situation which is contemplated here is where the parties enter into a commercial transaction under a mistake of fact or law.<sup>232</sup> During the course of the transaction, the plaintiff paid over money or entrusted goods to the insolvent. The discovery of common mistake showed that the mutual intention of the parties is

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<sup>229</sup> (1881) 20 Ch D 1, 12-13.

<sup>230</sup> Duggan, above n 69, [606].

<sup>231</sup> See Andrew Lang, 'Practical Problems in the Sale of a Business 1' in Andrew Lang (ed), *Practical Problems in the Sale of Business* (1998) 2-18.

<sup>232</sup> As to the Australian approach, see *David Securities Pty Ltd v Commonwealth Bank* (1992) 175 CLR 353; Mason and Carter, above n 95, [413]-[414].

vitiated and the transaction was no longer commercially viable. In such a situation equity will intervene. Greig and Davis have stated:

If the parties have entered into a contract on the basis of a common mistake, the contract is generally valid at law...But for one party to insist on continued performance of the contract after the mistake has been discovered is the same sort of (*sic*) 'moral fraud' or 'moral delinquency' as permits the rescission of a contract induced by a non-fraudulent misrepresentation. To insist on maintaining the benefits of the contract when the error is revealed may well amount to unconscionable conduct.<sup>233</sup>

It is established that equity will intervene where it can be seen that the common mistake was a serious one (such as a total failure of consideration)<sup>234</sup> which went to the heart of the transaction<sup>235</sup> and it would be unconscionable for the one party to retain 'the windfall'.<sup>236</sup> The traditional personal remedy for common mistake is rescission.<sup>237</sup>

In this situation, the creditor should be entitled to proprietary relief,<sup>238</sup> in the event of the other party's insolvency. The creditor could assert that he did not assume the status of an unsecured creditor. The unconscionable conduct of the insolvent placed him in that position. An insolvent would be unable to argue that the creditor failed to preserve his interests because the insolvent has also failed to do so.

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<sup>233</sup> Greig and Davis, above n 75, 917; *Solle v Butcher* [1950] 1 KB 671, 693 (Lord Denning); *Magee v Pennine Insurance Co* [1969] 2 QB 507, 514 (Lord Denning); cf Meagher, Gummow and Lehane, above n 69, [1436].

<sup>234</sup> *Svanosio v McNamara* (1956) 96 CLR 186, 198 (Dixon CJ and Fullagar J); 203-204 (McTiernan, Williams and Webb JJ).

<sup>235</sup> *Lukacs v Wood* (1978) 19 SASR 520, 529-531 (Jacobs J).

<sup>236</sup> *Ibid* 531 (Jacobs J).

<sup>237</sup> *Magee v Pennine Insurance Co Ltd* [1969] 2 QB 507, 514 (Lord Denning).

<sup>238</sup> Scott and Fratcher, above n 63, vol V, § 465, 334-339.

### (c) *Void Contracts*

Two situations require comment. One situation is where there is the lack of capacity of one of the parties involved in the transaction. Such incapacity may arise by virtue of specific legislation which confirms the legal incapacity of certain persons to enter certain contracts and renders the contract void.<sup>239</sup> This will not be further pursued. However, the incapacity may be enshrined in the nature of the legal entity entering into the transaction. For some time, the capacity of the modern corporation was constrained by the mandatory objects clause in the memorandum of association.<sup>240</sup> However, the capacity of corporations, registered in Australia, to act as a natural person was set down in legislation in 1983.<sup>241</sup> Therefore, in recent years, the ultra vires issue has not been so critical in relation to corporations.<sup>242</sup> But, as recent English cases show, it can still create difficulties where unincorporated bodies, such as municipal councils are unaffected by legislative amendments to the ultra vires doctrine.<sup>243</sup>

The other situation is where there are transactions which both parties mistakenly enter into and are rendered void by statute.

These situations are sometimes determined in the light of the law of restitution.<sup>244</sup> However, as the argument of the thesis makes clear, when seeking equitable proprietary relief, the considerations encapsulated in the theory of objective non-assumption of risk should be applied notwithstanding that it is arguable that a claim in restitution is involved.

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<sup>239</sup> Greig and Davis, above n 75, 777-780, 1090.

<sup>240</sup> HAJ Ford, RP Austin and IM Ramsay, *Principles of Corporations Law* (8<sup>th</sup> ed, 1997) [12.080]-[12.100].

<sup>241</sup> *Ibid* [12.110].

<sup>242</sup> *Ibid* [12.120].

<sup>243</sup> *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669; *Hazell v Hammersmith and Fulham London Borough Council* [1992] AC 1.

<sup>244</sup> See for example *Rover International Ltd v Cannon Film Sales Ltd* [1990] 1 WLR 912; Goff and Jones, above n 90, Chapters 3, 4, 23; Mason and Carter, above n 95, Chapter 4; SJ Stoljar, *The Law of Quasi-Contract*, (2<sup>nd</sup> ed, 1989) Chapter 2.

### (i) *Ultra Vires Contracts*

The concept of ultra vires encapsulates those situations where a director of a company has entered a contract outside his authority,<sup>245</sup> where a company has entered into a contract prior to incorporation (and therefore has acted beyond the power of a non-incorporated entity),<sup>246</sup> or where a company has acted outside its powers.<sup>247</sup>

The extent to which proprietary relief should be available in such cases is still largely undetermined, although the House of Lords in *Westdeutsche Landesbank Girozentrale v Islington London Borough Council*<sup>248</sup> broached it recently.

The facts of *Westdeutsche* are set out in Chapter 3.<sup>249</sup> What is relevant in this discussion is that the bank was entitled to a personal remedy. However, the bank was not entitled to compound interest because a majority of the court held that award of compound interest was only within equitable jurisdiction.<sup>250</sup> The fact that the local authority had received the money, unaware of the vitiating effect of the ultra vires, indicated that the jurisdiction of the equity jurisdiction based on conscience was not activated.

However, when setting out the basis for equitable intervention, the House of Lords took the opportunity to overrule *Sinclair v Brougham* ('*Sinclair*').<sup>251</sup> The facts of *Sinclair* are set out in Chapter 3. In a modern light, it can be said that the non-members had assumed the risks of the transaction, but they had not been aware that the actions of the building society were ultra vires. This vitiated the original intentions of the depositors. The majority judgments in *Westdeutsche* failed to

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<sup>245</sup> *Craven-Ellis v Canons Ltd* [1936] 2 KB 403; *Guinness plc v Sanders* [1990] 2 AC 663.

<sup>246</sup> *Rover International Ltd v Cannon Film Sales Ltd* [1989] 1 WLR 912.

<sup>247</sup> *Sinclair v Brougham* [1914] AC 398; *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669.

<sup>248</sup> [1996] AC 669.

<sup>249</sup> Chapter 3, 124-125.

<sup>250</sup> [1996] AC 669, 717-718 (Lord Browne-Wilkinson).

<sup>251</sup> [1914] AC 398.

consider the broadening notion of unconscionable conduct. Therefore, it is contended that the House of Lords was incorrect when it overruled *Sinclair* or (in the light of the wide variety of judgments in the case) the result in *Sinclair*. The non-members were entitled to proprietary relief. They were entitled to assume that the building society was acting within its powers. There was no market practice which required investigation of the legal status and capacity of the building society. It would have been unconscionable for the building society to have retained money under a void contract. There was no legitimate basis upon which the society could receive and retain funds. This did not change because the society became insolvent. Such an approach would be consistent with equity's approach to common mistake.

However, such reasoning does not automatically imply that proprietary relief should be available in all cases. For example, a large corporate lender which failed to discover that a company director entered into a loan contract outside his authority or a borrowing company had acted ultra vires, may not be entitled to such relief. It may be established that it had not taken sufficient care to preserve its own interests and investigate the status of the director and the company. It may not have followed prudent market practice.

## ***(ii) Mistaken Transactions made Void by Statute***

Allied to the concepts of common mistake and illegality (which are considered below), parties may mistakenly enter into a contract which is rendered void by statute. This was the situation which occurred in *David Securities Pty Ltd v Commonwealth of Australia* ('*David Securities*')<sup>252</sup> where a borrower entered a contract in which it was required to pay tax to the lender under the mortgage. The High Court of Australia held that the loan was caught by taxation legislation<sup>253</sup> which rendered such obligations void.<sup>254</sup> The Court held that the borrower was entitled to recover those moneys which had been mistakenly paid over on the basis that there was a legal obligation to pay them.<sup>255</sup> Once the mistake was proved, further

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<sup>252</sup> [1992] 175 CLR 353.

<sup>253</sup> *Income Tax Assessment Act 1936* (Cth) s 261.

<sup>254</sup> [1992] 175 CLR 353, 361-367 (Mason CJ, Deane, Toohey, Gaudron and McHugh JJ).

<sup>255</sup> *Ibid.*



proof of the unjust retention of the funds was unnecessary.<sup>256</sup> It was sufficient that the mistake was causative but not fundamental.<sup>257</sup>

As the lender was solvent, it was unnecessary to consider the situation where proprietary relief was sought. However, where a contract is rendered void by virtue of its breach of a legislative provision, such a borrower should be entitled to proprietary relief. As in the cases of common mistake and ultra vires contracts, there is no conscionable basis upon which the lender should be able to retain funds. The borrower's unsecured status would be directly connected to the ineffective contract and the lender's unconscionable retention of the funds. When applying the theory of objective non-assumption of risk, market practice will be an important criterion. In *David Securities*, the plaintiff was not expected to minimise the risks associated with the terms of the transaction. As a borrower, the plaintiff was obliged to comply with the lender's requirements. Generally, borrowers are not required to investigate the legality of the lender's borrowing requirements. Moreover, borrowers in this situation rely on the expertise of the lender to ensure that the transaction is legally valid.

#### ***(d) Ineffective Contracts - Failure to Comply with Formalities***

A contract which is ineffective due to a failure to comply with formalities is unenforceable but it is not void.<sup>258</sup> Both equity, via the doctrine of part performance,<sup>259</sup> and modern restitution<sup>260</sup> have responded to provide personal relief. Otherwise, the insolvent and his creditors would obtain a windfall due to the unenforceable nature of the contract. In recent times, the failure to comply with formalities has arisen most clearly in quantum meruit cases where a party has provided services ignorant of the fact that the contract does not comply with

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<sup>256</sup> Ibid 379.

<sup>257</sup> Ibid 376-378.

<sup>258</sup> Greig and Davis, above n 75, 715-717; *Maddison v Alderson* (1883) 8 App Cas 467.

<sup>259</sup> *Maddison v Alderson* (1883) 8 App Cas 467, 475 (Lord Selborne LC); *McManus v Cooke* (1887) 35 Ch D 681. For a comprehensive discussion of part performance in modern times see Meagher, Gummow and Lehane, above n 69, [2036]-[2045].

<sup>260</sup> *Degelman v Guaranty Trust Co of Canada and Constantineau* [1954] 3 DLR 785; *Pavey & Matthews Pty Ltd v Paul* (1986) 162 CLR 221.

legislative requirements.<sup>261</sup> Notwithstanding the non-compliance, the service provider has been able to claim an amount in payment for services rendered.

However, in such cases the party to whom the service was provided was not insolvent. If there had been an intervening insolvency, then the question ought to have been whether, objectively speaking, the service provider assumed the risk of an unsecured creditor. It is by no means clear that a creditor could establish objective non-assumption of risk of the transaction in all cases. An objective evaluation of market practice would be necessary.

### ***(e) Contracts Discharged for Frustration or Breach***

Contracts discharged for frustration or breach are neither void or voidable. They are valid contracts. Up to the time of discharge, the contract is fully enforceable and thereafter the terms and conditions of the contract remain operative.<sup>262</sup> It can be assumed in these cases that each of the parties have taken on the risk of the potential insolvency of the other, that they have thoroughly investigated the financial status of the other party (if they considered it necessary) and they have regulated their relationships on the basis that the contract sets out the terms and conditions of the relationship (including what is precisely to occur where there is a breach of contract). They have accepted that the primary remedy for breach of contract will be damages. By entering into the contract, they have generally accepted the prevailing norms of commercial operation and they may not have taken security from one another in anticipation of breach of contract. In the case of discharge by breach, it is likely that in many cases a plaintiff will only be allowed to rely on contract rather than a claim in restitution. This issue is interrelated with the complex matter of the nature and extent of the failure of consideration required.<sup>263</sup> The limited scope of the availability of restitution has been criticised.<sup>264</sup> But, whether the claim is made on the basis of damages for breach or the limited head under restitution based on total failure of

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<sup>261</sup> *Pavey & Matthews Pty Ltd v Paul* (1986) 162 CLR 221.

<sup>262</sup> *McDonald v Dennys Lascelles Ltd* (1933) 48 CLR 457, 476-477 (Dixon J); *Johnson v Agnew* [1980] AC 347, 367, 392-398 (Lord Wilberforce).

<sup>263</sup> As Goff and Jones, above n 90, 412-413; *Rowland v Divall* [1923] 2 KB 500; *Rover International Ltd v Cannon Film Sales Ltd* [1989] 1 WLR 912; *Goss v Chilcott* [1996] AC 788, 797 (Lord Goff).

<sup>264</sup> Burrows, above n 217, 259-261; E McKendrick, 'Total Failure of Consideration and Counter-Restitution: Two Issues or One' in P Birks (ed), *Laundering and Tracing* (1995) Chapter 8.

consideration, only a personal remedy should be available. Generally, a proprietary remedy should not be awarded.<sup>265</sup> The only exception which would arise is where contract is subject to specific performance on the basis that the subject matter of a sale contract was rare or unique. Equity would provide a specific remedy with proprietary consequences.<sup>266</sup>

Contracts which are discharged through frustration are governed by legislation which sets out the rights of the parties and the allocation of risk.<sup>267</sup> The legislation was in response to the defects in the common law such as the need for total failure of consideration,<sup>268</sup> the general denial of an action based on quantum meruit<sup>269</sup> and the denial of the defence of change of position.<sup>270</sup> However, a perusal of the various forms of legislation<sup>271</sup> shows that there is no allocation of risk which is influenced by the insolvency of the parties. The remedies under the various forms of legislation are based on the premise that the remedy which will be awarded will be a personal remedy.

The only possible exception to the position stated above is where the frustrating event has direct bearing on the insolvency of the defendant such as in *Re Kayford Ltd (in liq)*.<sup>272</sup>

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<sup>265</sup> See Worthington, above n 221, 168-171.

<sup>266</sup> Ibid 171-172; *Fells v Read* (1796) 3 Ves Jun 71; 1 Ves Jun Supp 334; 30 ER 899; 34 ER 814; *Dougan v Ley* (1946) 71 CLR 142. In relation to the breadth of equitable jurisdiction to restore chattels in specie see *Burr v Bloomsburg* 138 A 876 (Court of Chancery New Jersey, 1927).

<sup>267</sup> *Law Reform (Frustrated Contracts) Act 1943* (UK); *Frustrated Contracts Act 1959* (Vic); *The Frustrated Contracts Act 1978* (NSW).

<sup>268</sup> *Whincup v Hughes* (1871) LR 6 CP 78.

<sup>269</sup> *Cutter v Powell* (1796) 6 TR 320; 101 ER 573.

<sup>270</sup> For a discussion of change of position see below 340-342.

<sup>271</sup> For a discussion of the various forms of legislation such as the *Frustrated Contracts Act 1959* (Vic) or *Frustrated Contracts Act 1978* (NSW) see Greig and Davis, above n 75, 1336-1350; Carter and Harland, above n 222, [2068]-[2098].

<sup>272</sup> [1975] 1 WLR 279.

### *(f) Incomplete or Anticipated Contracts*

Generally, the situations which arise under this heading pertain to a disgruntled party providing services pursuant to an incomplete contract or an anticipated contract. Therefore, it falls outside the scope of this thesis. However, such situations stand in contrast to the proprietary estoppel situation identified previously. The problem for providers of services in the circumstances presently under consideration is whether they will be able to obtain personal relief based on the services rendered. Such plaintiffs have been successful either on the basis of equitable estoppel<sup>273</sup> or quantum meruit.<sup>274</sup> Such plaintiffs will effectively argue that the relationship was such that it was tantamount to a valid contract operating, because there was detrimental reliance on the representations of the other party that a contract would come into operation in the future,<sup>275</sup> that there was a request made to the plaintiff to undertake the work<sup>276</sup> or free acceptance.<sup>277</sup> What is clear is that where the party has rendered services pursuant to an incomplete contract or in anticipation of a contract, that party has taken on the risk of the other party's potential insolvency whether or not there is a contract in existence. It is probable that the party has not even undertaken normal market practice because the party had simply provided services without taking protective measures, including having the terms of the relationship set out in a complete contract. Where money is transferred, rather than services rendered, the same analysis will apply. Therefore, as personal relief is available, proprietary relief should not be available to a party who has performed services or paid money pursuant to an incomplete contract or in anticipation of a contract.

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<sup>273</sup> *Waltons Stores (Interstate) Ltd v Maher* (1988) 164 CLR 387.

<sup>274</sup> *William Lacey (Hounslow) Ltd v Davis* [1957] 1 WLR 932; *Sabemo Ltd v North Sydney Municipal Council* (1977) 2 NSWLR 880.; *British Steel Corporation v Cleveland Bridge and Engineering Co Ltd* [1984] 1 All ER 504; *Marston Construction Co Ltd v Kigass Ltd* (1989) 46 BLR 109; *Brenner v First Artists' Management Pty Ltd* [1993] 2 VR 221; *Angelopoulos v Sabatino* (1995) 65 SASR 1.

<sup>275</sup> *Waltons Stores (Interstate) Ltd v Maher* (1988) 164 CLR 387, 403-406 (Mason CJ and Wilson J), 417-430 (Brennan J).

<sup>276</sup> *Brenner v First Artists' Management Pty Ltd* [1993] 2 VR 221.

<sup>277</sup> *Angelopoulos v Sabatino* (1995) 65 SASR 1, 6-13 following *Pavey & Matthews Pty Ltd v Paul* (1986) 162 CLR 221.

### 3 *Mutual Omissions*

#### (a) *Introduction*

The situations considered here occur when the parties have failed to set out or make clear their full intentions. In the past, courts have presumed or inferred the intention of the parties to a contract in the form of implied terms.<sup>278</sup> Therefore, it is arguable that what is occurring is that courts have effectively inferred the mutual intention of the parties in much the same fashion as courts dealing with the *de facto* relationships cases.<sup>279</sup> However, this is not the correct approach and it ought not be pursued. Rather, it is better to evaluate the transaction in the light of the theory of objective non-assumption of risk. In the mutual omission cases, the broad nature of the context will be that the insolvent received funds in circumstances which were not envisaged by the parties. In this sense, the cases are similar to the subsequent unconscionable conduct cases. However, the 'triggering event' does not necessarily bring the contract or relationship to an end. It may simply affect one transaction within an ongoing relationship. Then the recipient becomes insolvent. The creditor could not be expected to have foreseen the situation or to have taken precautionary steps in the light of market practice. The creditor requests the insolvent or its administrator to disgorge the money (or the monetary equivalent). The insolvent, knowing the circumstances of the payment, unconscionably refuses to repay the same to the creditor.

#### (b) *Mistaken Payments*

Courts have considered situations where there is an ongoing relationship in which an insolvent received mistaken payments and/or overpayments. It appears that there are a variety of jurisdictions where a genuine error on the part of a creditor does entitle the creditor to proprietary relief.<sup>280</sup>

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<sup>278</sup> *The Moorcock* 14 PD 64, 68 (Bowen LJ); *Liverpool City Council v Irwin* [1977] AC 239; *Tai Hing Cotton Mill Ltd v Lui Chong Hing Bank Ltd* [1986] AC 80.

<sup>279</sup> In relation to the latter see *Allen v Snyder* [1977] 2 NSWLR 685.

<sup>280</sup> For England see *Chase Manhattan Bank NA v Israel-British Bank (London) Ltd* [1981] Ch 105. In relation to Australia, see *Australia and New Zealand Banking Group Ltd v Westpac Banking Corporation* (1988) 164 CLR 662. In relation to Canada, note *Harper and Royal Bank of Canada; Re/Max Renown Realty, Third Party* 114 DLR (4th) 749 and the comments of Peter D Maddaugh and

Mere negligence in making a payment will not disentitle the creditor to personal relief<sup>281</sup> and it appears that such negligence should not, in principle, impair prospects for proprietary relief.<sup>282</sup> However, the fact that there has been some lack of care on the part of the creditor should be a consideration when deliberating whether or not the court should award proprietary relief, particularly where the other unsecured creditors of the insolvent have not acted negligently.<sup>283</sup>

One scenario is where the plaintiff makes an overpayment or pays the insolvent twice (which is in itself an overpayment). The overpayment is made on the basis of the innocent mistake of the creditor. In *Chase Manhattan Bank NA v Israel-British Bank (London) Ltd*<sup>284</sup> the creditor mistakenly transferred \$2 million twice to another bank. Goulding J held that the plaintiff had acquired a proprietary interest by virtue of the mistake which entitled it to recoup the money which had been paid over twice.<sup>285</sup> However, this method of finding a proprietary interest has been criticised in Chapter 3.<sup>286</sup>

Another scenario is where the plaintiff pays funds to the insolvent under the mistake that he is indebted to the defendant and/or the defendant makes an erroneous

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John D McCamus, *The Law of Restitution* (1990) 239-240. For the United States see *Re Berry* 147 F 208 (2<sup>nd</sup> Cir, 1906); American Law Institute, *Restatement of the Law of Restitution* (1937) §163; Davis, above n 166, 56-57; Emily L Sherwin, 'Constructive Trusts in Bankruptcy' [1989] *University of Illinois Law Review* 297, 357-361.

<sup>281</sup> *Kelly v Solari* (1841) 9 M & W 54; 152 ER 24; *White v Copeland* (1894) 15 LR (NSW) 281; *Imperial Bank of Canada v Hamilton* [1903] AC 49; *RE Jones Ltd v Waring Gillow, Ltd* [1926] AC 670; *Commercial Bank of Australia v Younis* [1979] 1 NSWLR 444; *National Westminster Bank Ltd v Barclays Bank International Ltd* [1975] 1 QB 654; *Westpac Banking Corporation v ATL Pty Ltd* [1985] 2 Qd R 577.

<sup>282</sup> See the result in *Chase Manhattan NA v Israel-British Bank (London) Ltd* [1981] Ch 105.

<sup>283</sup> Note in this regard, *Lane Bryant Inc v Vichele Tops Inc (In re Vichele Tops Inc)* 62 Bankr 788 (Bankr EDNY, 1986).

<sup>284</sup> [1981] Ch 105.

<sup>285</sup> *Ibid.* Note also *Australia and New Zealand Banking Group Ltd v Westpac Banking Corporation* [1988] 164 CLR 662. In relation to mistaken gifts and overpayment see generally *Lady Hood of Avalon v Mackinnon* [1909] 1 Ch 476; *Barclays Bank Ltd v WJ Simms Son & Cooke (Southern) Ltd* [1980] 1 QB 677, 686-699 (Goff J).

<sup>286</sup> Chapter 3, 119-121.

demand on the plaintiff which the plaintiff believes is a valid demand of payment.<sup>287</sup> Here, personal relief has been available. A developing area is where a bank honours a cheque under mistake and therefore advances its own money to the payee. Courts are increasingly willing to permit banks to bring a personal action to recover such payments. Money which is paid due to a mistake is *prima facie*, recoverable by a bank<sup>288</sup> subject to various defences including change of position.<sup>289</sup> Therefore, when a bank pays funds mistakenly in ignorance of the customer stopping the cheque,<sup>290</sup> the death or incapacity of the customer or forgery,<sup>291</sup> the bank will have a personal claim against the payee (rather than the customer who did not provide a genuine mandate for the bank to follow).<sup>292</sup> If the bank is unable to bring an action against the payee it will have no remedy. This situation has been criticised on the basis that it is inappropriate to take action against the payee where the customer has stopped the cheque.<sup>293</sup> However, there is no reason to suggest that the position should be any different where proprietary relief is sought. Whilst the bank did intend to make the payments, that intention was vitiated by circumstances which were unknown to the bank. It could be argued that banks, when honouring cheques, should be required to make careful investigations prior to honouring them. However, the careful cross-checking of every transaction would slow down the banking process inordinately. It

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<sup>287</sup> *Ex parte Simmonds*; *Re Carnac* (1885) 16 QBD 308; *Re Brown*; *Dixon v Brown* (1886) 32 Ch D 597, 602 (Kay J); *Re Opera Ltd* [1891] 2 Ch 154; *Re Rhoades*; *Ex parte Rhoades* [1899] 2 QB 347, 355 (Lindley MR); *Re Berry* 147 F 208 (2<sup>nd</sup> Cir, 1906); *Re Paddington Town Hall Centre Ltd* (1979) 41 FLR 239; *Re Kelly* (1980) 108 DLR (3d) 149; *Hartogen Energy Ltd v The Australian Gas Light Company* (1992) 36 FCR 557, 572-573 (Gummow J).

<sup>288</sup> *Barclays Bank Ltd v WJ Simms Son & Cooke (Southern) Ltd* [1980] 1 QB 677; Cranston, above n 190, 265-270.

<sup>289</sup> Alan Tyree, *Banking Law in Australia* (3<sup>rd</sup> ed 1998) [6.25]-[6.27].

<sup>290</sup> Tyree, above n 289, [6.37]-[6.38].

<sup>291</sup> *Ibid*, [6.42]-[6.46]; *Imperial Bank of Canada v Bank of Hamilton* [1903] AC 49; *National Westminster Bank Ltd v Barclays Bank International Ltd* [1975] QB 654.

<sup>292</sup> See the judgment of Goff J in *Barclays Bank Ltd v WJ Simms Son & Cooke (Southern) Ltd* [1980] 1 QB 677, 699-700.

<sup>293</sup> Tyree, above, n 289, [6.40]; RM Goode, 'The Bank's Right to Recover Money Paid on a Stopped Cheque' (1981) 97 *The Law Quarterly Law Review* 254, 262-264; KG Nicholson, 'Recovery of Money Paid Under a Mistake of Fact' (1986) 60 *The Australian Law Journal* 459. Note also the possible use of subrogation: *Liggett B (Liverpool) Ltd v Barclays Bank Ltd* [1928] 1 KB 48.

bank had investigated the customer's financial prospects, it would not have provided the loan accommodation, the problem for the bank is that the erroneous payment has been made due to its failure to investigate the financial status of the customer rather than the negligence of the payee or the customer.

Finally, there is the situation where a plaintiff pays the funds to the wrong person under a clear mistake of fact. For example in *Lane Bryant Inc v Vichele Tops Inc (In re Vichele Tops Inc)*,<sup>298</sup> the plaintiff had written and forwarded a cheque mistakenly to the defendant which deposited the cheque in its bank account. There was no doubt that the plaintiff could bring an action on this ground. The problem for the court, which ultimately negated the claim for proprietary relief, was the negligence of the claimant.<sup>299</sup> The view was that the plaintiff ought to have taken more care.

### ***(c) Double Receipts or Interests***

Another situation where parties fail to delineate what should happen when the insolvent receives twice its entitlement under the transaction. There is some analogy between this situation and the traditional authority in which the interests of vendors and purchasers under contracts for sale of land were protected by the imposition of liens<sup>300</sup> or purchasers of future property were protected by equitable assignments for consideration.<sup>301</sup> Equity intervened where one party had completely fulfilled his part of the bargain and the other party had not fulfilled the terms of the contract. In each case, equity imposed either a lien or a constructive trust to secure the completion of the contract.

In relation to monetary transfers and receipts, the sorts of situations which may arise are those where the insolvent actually receives twice the entitlement under the contract. In a sense, there has been an overpayment, but the overpayment has

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<sup>298</sup> 62 Banker 788 (Banker EDNY, 1986).

<sup>299</sup> For a consideration of this issue see Chapter 7, 332-335.

<sup>300</sup> Chapter 2, 74-76; Chapter 7, 295-296. For a comprehensive discussion of the relationship between vendors and purchaser in land sale contracts see DWM Waters, *The Constructive Trust: The Case for a New Approach on English Law* (1964) Chapter II; M Cope, *Constructive Trusts* (1992) Chapter 25.

<sup>301</sup> Chapter 2, 75-77; Note in this context *Palette Shoes Pty Ltd v Krohn* (1937) 58 CLR 1.



a trust,<sup>307</sup> the Court went on to water down the obligatory nature of segregation. In an informative (but a conceptually disordered) judgment, de Jersey J sidestepped the requirement for segregation as a manifestation of intention. He said that a requirement to segregate funds could be discerned and imputed from the transaction itself.<sup>308</sup> Thereafter, when the purpose for which the money was deposited came to an end, a resulting trust arose in favour of the depositor. He based his decision on a form of inferred or imputed intention. However, the case also signified that other analyses were emerging as well. He pointed out that he doubted that the existence of a trust was dependent on intention and referred (almost intuitively) to an emerging jurisprudence based on objective non-assumption of risk when he said:

Had one asked the plaintiff, it would have said of course, that it expected the moneys to be paid, as a fund, to the extent to which they were not expended following default by the lessees. The plaintiff apparently had no intention of associating with EAL as a mere investor. Likewise EAL, having regard to the peculiar circumstances of this deposit, would, if asked, have conceded an obligation to keep the moneys in a discreet identifiable fund, whether with EAL or invested by it, so that they would be readily available for payment to Financial Services [the lessor] if necessary, and ultimately, repayment for the plaintiff.<sup>309</sup>

De Jersey J could have resolved the simple but practically critical issue by recourse to an objective test of assumption of risk. A common-sense commercial approach would indicate that the guarantor had accepted the risk that it could lose the funds (due to the default of the lessee) or when the entity in which it deposited funds may become insolvent in the future. However, the period of risk taking on the part of the guarantor came to an end; and, objectively speaking, there was no longer any commercial reason why the bank was entitled to retain the funds. For this reason, the bank was required to disgorge them or (as in this case) a monetary equivalent.

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<sup>307</sup> Ibid 84.

<sup>308</sup> Ibid.

<sup>309</sup> Ibid.

## IV CONCLUSION

A major contention of this thesis is that the intervention of modern equity is explicable on the basis of whether an aggrieved party could be expected to assume the risk of the commercial transaction. From the identification of this criterion, a theory of objective non-assumption of risk has been posited.

In this chapter, the theory of objective non-assumption of risk has been given practical application. This chapter complements chapter 5. It provides a context to and a practical delineation of the kinds of situations where the principles enunciated in that chapter are likely and unlikely to apply. The situations which have been discussed are not exhaustive. This is because commercial persons and their lawyers are constantly creating new and varied commercial vehicles. Moreover, the protective methods for the minimisation of risk are constantly changing in response to such commercial vehicles.

However, the occasions where the theory ought to apply in favour of an unsecured creditor are limited and do not undermine the need for certainty in commercial transactions. The theory of objective non-assumption of risk draws on the modern foundation of traditional equitable relief and extends the scope for such relief. Its operation shows that equity is capable of intervening in commercial relationships on a principled basis targeting unconscionable conduct. Thus this chapter also complements Chapter 2.

Having established a principle upon which equitable intervention in commercial relationships may be explained and provided an illustration of how it may operate, the next issues are - what form will the proprietary remedy take and can the insolvent raise any defences against proprietary relief?

## **Chapter 7**

### **EQUITY'S DOMAIN: REMEDIES AND DEFENCES**

## I INTRODUCTION

The last two chapters were devoted to the elucidation and practical application of the theory of objective non-assumption of risk. They were predicated on the basis that equity should be able to provide proprietary relief as a response to unconscionable conduct (subject to any defences which the insolvent may raise). This chapter considers the two remaining and necessary components of the objective non-assumption of risk theory, namely, the appropriate proprietary remedy and defences.

Equity has utilised a wide array of mechanisms in response to unconscionable conduct. In the following discussion, these measures are detailed. However, in the light of the complexity of monetary transactions and the negotiability and fungibility of money, it will be argued that one remedial response, a general equitable lien, is preferable to the rest. This discussion covers material which is separate from that contained in Chapter 4. It will be recalled that it was argued in that chapter that the necessity for a proprietary base as a precondition to proprietary relief is no longer tenable. The technological complexity of money makes it impossible to reify, segregate and trace money into a proprietary base. Instead, what was essential to identify was whether the creditor objectively assumed the commercial consequences of the transaction.

## II REMEDIES FOR UNCONSCIONABLE CONDUCT

Traditionally, the common law has provided personal rather than proprietary remedies in the form of damages.<sup>1</sup> Even where the common law has provided proprietary relief in the form of finding that title has not passed or common law tracing, such relief has been beset by limitations.<sup>2</sup>

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<sup>1</sup> *Robinson v Harman* (1848) 1 Ex 850; 154 ER 363. Modern examples can be found in *Johnson v Agnew* [1980] AC 367, 392, 400 (Lord Wilberforce); *Pennant Hills Restaurants Pty Ltd v Barrell Insurances Pty Ltd* (1981) 145 CLR 625, 637 (Gibbs J); *Mahoney v J Kruschich (Demolitions) Pty Ltd* [1985] 156 CLR 522, 527. For a comprehensive discussion of common law damages and contract see: DR Harris, 'Damages' in AG Guest (ed), *Chitty on Contracts* (27<sup>th</sup> ed, 1994) vol 1, Chapter 26 and DW Greig and JLR Davis, *The Law of Contract* (1987) Chapter 23. For a discussion of common law damages and tort see RP Balkin and JLR Davis, *Law of Torts* (2<sup>nd</sup> ed, 1996) Chapters 11 and 27.

<sup>2</sup> In relation to common law tracing see Chapter 2, 65-66.

Instead, it can be argued that it was the Chancery and then the modern jurisdiction of equity which has developed proprietary relief (or relief which has proprietary consequences such as specific performance)<sup>3</sup> in a sophisticated way.

### ***A Common Law and Equitable Proprietary Responses to Unconscionable Conduct***

There have been a wide variety of responses to unconscionable conduct which have, or could have, a significant proprietary effect in insolvency situations, where the transfer or receipt of money is concerned. The following discussion will inevitably draw on remedies which have been used in response to the kinds of unconscionable conduct which have been considered in the preceding chapter. However, the discussion in the main, will focus on *equitable* responses which have a proprietary effect in insolvency situations. Each of the methods are described and evaluated in the light of the practical and legal complexity of monetary transactions.

#### ***1 Title Has Not Passed***

The theory that title has not passed to goods or money is a recurrent theme for determining proprietary rights to goods under legislation and 'Romalpa' clauses.<sup>4</sup> However, the theory also arises where certain kinds of vitiating events occur such as mistake.<sup>5</sup> Referring to contracts which are vitiated by various kinds of mistake, Greig and Davis have stated:

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<sup>3</sup> Sarah Worthington, *Proprietary Interests in Commercial Transactions* (1996) 198-206. Note also John Glover, 'Equity, Restitution and the Proprietary Recovery of Value' (1991) 14 *The University of New South Wales Law Journal*, 247, 254-262.

<sup>4</sup> See *Aluminium Industrie Vaassen BV v Romalpa Aluminium Ltd* [1976] 1 *Lloyd's Reports* 443 (Mocatta J); affirmed [1976] 1 WLR 676 (CA). Other cases where the Romalpa clause has been considered include *Borden (UK) Ltd v Scottish Timber Products Ltd* [1981] Ch 25; *Clough Mill Ltd v Martin* [1985] 1 WLR 111; *Hendy Lennox (Industrial Engines) Ltd v Grahame Puttick Ltd* [1984] 1 WLR 485; *Armour v Thyssen Edelstahlwerke AG* [1991] 2 AC 339; *Re Weldtech Equipment Ltd* [1991] BCC 16; *Compaq Computer Ltd v Abercorn Group Ltd* [1991] BCC 484. For helpful discussions of Romalpa clauses see John Parris, *Effective Retention of Title Clauses* (1986); JR Bradgate, 'Reservation of Title Ten Years On' (1987) 51 *Conveyancer* 434; Sally Wheeler, *Reservation of Title Clauses: Impact and Implications* (1992); MG Bridge, 'Form, Substance and Innovation in Personal Property Security Law' [1992] *Journal of Business Law* 1; Gerard McCormack, *Reservation of Title*, (2<sup>nd</sup> ed, 1995); Worthington, above n 3, Chapter 2.

<sup>5</sup> Worthington, above n 3, 124-125.

In each of these situations, although it is possible to speak of a 'void contract', the reality is that, because of the lack of assent by one party to the terms proposed by the other, the necessary mutuality of a contractual obligation has failed to materialise. Neither party can be under any obligation to the other, and anything done in purported performance of the 'contract' has no effect. In particular, the delivery of goods by one to the other in pursuance of such an arrangement does not result in any change of ownership.<sup>6</sup>

This interpretation is logically valid because if the contract is void, then there is no relationship between the parties and anything undertaken pursuant to the contract is rendered nugatory by the very void nature of the 'contract.'

However, where void contracts are involved, the practice of legislatures and courts is more complex. For example, in relation to statutory schemes contracts with minors and gaming contracts, contracts are treated as void whilst executory. However, such contracts appear otherwise to have full effect and operation.<sup>7</sup> The problem is that whilst the contract is technically void, the parties have treated the relationship created by the contract as fully operational and binding. They could no longer argue that they have not benefited from the contract and both parties were willing to perform the contract. Where the contract is void, due to mistake or ultra vires, courts have been faced with the same dilemma. The parties have often acted for some time on the basis that the contract between them was valid.

Whilst it may be possible to argue that title to identifiable personal property has not passed, the analysis breaks down where money is concerned. The problem in *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* ('*Westdeutsche*')<sup>8</sup> was that the contract between the parties was void because the swap arrangement was ultra vires. Nonetheless, the parties had acted on the basis that the contract was valid for some time. The crucial fact was that although the bank's claim was legitimate in the light of the void contract, the bank was unable to claim proprietary relief simply on the basis of the fact that the contract was void. Money is essentially a negotiable commodity.<sup>9</sup> Where money is paid pursuant to a void

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<sup>6</sup> Greig and Davis, above n 1, 1086; Note also SJ Whittaker, 'Chapter 1 - Introductory' in AG Guest (ed), *Chitty on Contracts* (27<sup>th</sup> ed, 1994) vol 1, 1, [1-023].

<sup>7</sup> Greig and Davis, above n 1, 1090-1093.

<sup>8</sup> [1996] AC 669.

<sup>9</sup> Chapter 1, 12-13.

contract, there are two fundamental legal principles essentially at odds with one another. Theoretically, title (legal or equitable) does not pass pursuant to a void contract. On the other hand, money, in whatever guise it may take, functions quite easily as a negotiable commodity. Indeed, in *Westdeutsche*, it is likely that the money transferred throughout the transaction would have generally been paperless and ephemeral.<sup>10</sup> The implication of the decision was that the normative and practical function of money militates against the concept of reservation of title - even in circumstances where there is a serious vitiating factor which subverts the legal efficacy of the transaction to the extent that it is theoretically void. Therefore, retention of title is a limited remedial response to unconscionable conduct.

## ***2 Following and Tracing***

It is submitted that the traditional rules of common law following and equitable tracing are embellishments of the concept of retention of title. The significance of both traditional common law following and equitable tracing rules is that they operate on the basis that the creditor who seeks to follow or trace must locate the asset in its original, mixed or substituted form. After locating the asset in its original, mixed or substituted form, the creditor can argue that he has retained title to that asset. However, the mechanical following and tracing processes which currently operate in our legal system are limited. Whilst they are sometimes helpful responses to wrongful conduct, they are not entirely effective. Therefore, in the light of the complexity of monetary dealings and transactional ephemerality, it may be impossible for a party to locate the money to which he alleges he retains title.<sup>11</sup> Accordingly, the common law following and equitable tracing rules are limited remedial responses to unconscionable conduct.

## ***3 Rescission***

Rescission is an important remedial response to many forms of unconscionable conduct<sup>12</sup> such as mistake,<sup>13</sup> misrepresentation,<sup>14</sup> duress,<sup>15</sup> undue

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<sup>10</sup> Ibid, 9-11.

<sup>11</sup> Chapter 2, 65-66; 68-70.

<sup>12</sup> See generally RP Meagher, WMC Gummow and JRF Leane, *Equity Doctrines and Remedies* (3<sup>rd</sup> ed, 1992) [2403]-[2404]; Louis Proksch, 'Rescission', in Patrick Parkinson (ed), *The Principles of Equity*, 1996) 856, [2502] and Keith Mason and JW Carter, *Restitution Law in Australia*, (1995) [1310].

influence<sup>16</sup> and unconscionable dealing.<sup>17</sup> Rescission was available both at common law and in equity. The common law version was notoriously difficult to satisfy<sup>18</sup> because an exact restoration of the parties to their former position was required.<sup>19</sup> However, where money was involved, this was not a problem because money is fungible and so precise and complete restoration was effectively possible.<sup>20</sup> Courts of equity operating in their concurrent jurisdiction<sup>21</sup> ordered rescission upon an even more flexible basis to achieve the near or practical restoration of parties to their previous position.<sup>22</sup> Ultimately, equity developed a more expansive and useful remedy of rescission than the common law.<sup>23</sup>

Rescission is an effective remedy for unconscionable conduct. Where a party has acted unconscionably in relation to transactions,<sup>24</sup> rescission operates to set them aside. The ultimate effect of rescission in common law and equity is the restoration of the parties to the position which they stood in prior to the transaction which, generally speaking, was the product of the unconscionable conduct. There may be an

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<sup>13</sup> Lord Goff of Chieveley and Gareth Jones, *The Law of Restitution* (4<sup>th</sup> ed, 1993), 212-220; Mason and Carter, above n 12, [1311].

<sup>14</sup> *Alati v Kruger* (1955) 94 CLR 216; *Abram Steamship Co Ltd v Westville Shipping Co Ltd* [1923] AC 773; Goff and Jones, above n 12, 183-212; Mason and Carter, above n 12, [1311].

<sup>15</sup> Mason and Carter, above n 12, [1312].

<sup>16</sup> Tony Duggan, 'Undue Influence', in Patrick Parkinson (ed), *The Principles of Equity* (1996) 379, [1128]; Mason and Carter, above n 12, [1313].

<sup>17</sup> Mason and Carter, above n 12, [1314] and [1316].

<sup>18</sup> Proksch, above n 12, [2503].

<sup>19</sup> *Erlanger v The New Sombrero Phosphate Co* (1878) 3 App Cas 1218, 1278-1279 (Lord Blackburn); *Sibley v Grosvenor* (1916) 21 CLR 469, 474-475 (Griffith CJ).

<sup>20</sup> Proksch, above n 12, [2503] fn 16.

<sup>21</sup> For a modern example see *Vadasz v Pioneer Concrete (SA) Pty Ltd* (1995) 184 CLR 102.

<sup>22</sup> *Erlanger v The New Sombrero Phosphate Co* (1878) 3 App Cas 1218, 1278-1279 (Lord Blackburn).

<sup>23</sup> *Ibid*; Proksch, above n 12, [2503]-[2504].

<sup>24</sup> Meagher, Gummow and Lehane, above n 12, [2403]-[2404].



act of rescission by the innocent party which reverts property.<sup>25</sup> Court action may be required in order to effect complete restoration of legal title, although it may not be necessary where equitable title is concerned.<sup>26</sup>

However, the effectiveness of rescission in insolvency contexts awaits testing. Rescission is characterised as a personal remedy (rather than a proprietary remedy) by which parties are restored to the position that they would have been in if the transaction had never taken place.<sup>27</sup> The remedy is supposed to operate retrospectively and the transaction (together with any obligations under it) is avoided.<sup>28</sup> The question is, how do these principles of rescission operate in relation to money in an insolvency context? Although equity is able to make orders which achieves equivalent restoration,<sup>29</sup> it is by no means completely clear that in all jurisdictions rescission is effective in insolvency situations. Both Worthington<sup>30</sup> and Hayton<sup>31</sup> argue that under the doctrine of rescission, the original title of the asset does revert after an effective election. So too, in the United States, there is material to suggest that proprietary relief is available in relation to a number of areas where rescission would be a traditional remedy. The recipient holds the subject property as a constructive trustee.<sup>32</sup> However, there have been some powerful statements that whilst rescission may be available, the creditor only acquires personal remedies in an insolvency situation.<sup>33</sup> In addition, there appears to be a need for identifiable

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<sup>25</sup> *Clough v The London & North Western Railway Co* (1871) LR 7 Ex 26, 34-35; *Hunter BNZ Finance Ltd v CG Maloney Pty Ltd* (1988) 18 NSWLR 420, 432-433 (Giles J).

<sup>26</sup> *Alati v Kruger* (1955) 94 CLR 216, 224 (Dixon CJ, Webb, Kitto and Taylor JJ).

<sup>27</sup> *Erlanger v The New Sombrero Phosphate Co* (1878) 3 App Cas 1218, 1278 (Lord Blackburn); cf David M Wright, *The Remedial Constructive Trust* (1998) [3.67]-[3.79].

<sup>28</sup> Proksch, above n 12, [2501].

<sup>29</sup> *Erlanger v The New Sombrero Phosphate Co* (1878) 3 App Cas 1218, 1278-1279 (Lord Blackburn).

<sup>30</sup> Worthington, above n 3, 164.

<sup>31</sup> David Hayton, 'Ascertainability in Transfer and Tracing of Title' (1994) *Lloyds Maritime and Commercial Law Quarterly*, 449, 452.

<sup>32</sup> In relation to the United States see Austin Wakeman Scott and William Franklin Fratcher, *The Law of Trusts* (4<sup>th</sup> ed, 1989) vol V §465-473.

<sup>33</sup> *Re Goldcorp Exchange Ltd (In Receivership)* [1995] 1 AC 74, 101-103 (Lord Mustill).

property in order for an effective rescission to take place.<sup>34</sup> However, in *Eldan Services Ltd v Chandag Motors Ltd*<sup>35</sup> Millett J said that even if the property is identifiable, that would not be sufficient to ground proprietary relief.<sup>36</sup>

Proksch has noted:

Where the transaction consists only of the payment of money, for instance under duress, rescission of the transaction is implicit in pursuit of an action for return of the money. In all these instances, rescission both dates from, and takes effect at, the time of the act of the party in electing to rescind.<sup>37</sup>

The statement assists in constructing one possible interpretation of how rescission operates in insolvency situations. In the light of the fact that money is fungible and negotiable, title to the money passes to the wrongdoer. Apprised of the wrongdoing, the innocent party rescinds the transaction and brings an action for a return of the money or, more accurately, a monetary equivalent. It is the act of rescission which brings the transaction to an end. On this analysis, it is arguable that rescission can only operate as a personal remedy, where the aggrieved is unable to trace the money and establish a proprietary base. Certainly, if the wrongdoer becomes insolvent prior to the act of rescission, then the operation of the remedy of rescission would entitle the party to personal relief in the form of a monetary equivalent of the amount originally transferred or collected. The consequence is that the party who has lawfully rescinded the contract stands as an unsecured creditor of the wrongdoing insolvent. A difficulty is that whilst a consistent and coherent application of rescission should result in the party's claim having a proprietary effect, rescission has no associated device which articulates the proprietary status of the successful creditor. This would suggest that it is solely a personal remedy or a remedy which has no proprietary effect.

The preceding interpretation undercuts the basic rationale of rescission. A common view is that the function of rescission is to restore the parties to the position

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<sup>34</sup> Worthington, above n 3, 165 and *Re Goldcorp Exchange Ltd (In Receivership)* [1995] 1 AC 101-103.

<sup>35</sup> [1990] 3 All ER 459.

<sup>36</sup> *Ibid*, 462.

<sup>37</sup> Proksch, above n 12, [2506].

which they would have been in if the transaction had never taken place.<sup>38</sup> If rescission simply operates as a personal remedy, then this would not be the case where the wrongdoer was insolvent. The practical restoration would be determined by the defendant's financial state of affairs, rather than the nature of the conduct which gave rise to the right of rescission.

An alternative interpretation emphasises that whilst rescission is primarily a personal remedy, it will have a proprietary effect where the wrongdoer is insolvent. The potential for rescission to have a proprietary effect has been recognised.<sup>39</sup> The problem with such earlier explanations is that the remedy of rescission is tied to and functions in a way akin to the resulting trust<sup>40</sup> and the need for identifiable property.<sup>41</sup> It has already been demonstrated that such reasoning is unhelpful and impractical.<sup>42</sup> The proprietary articulation of rescission needs to be established on a different basis.

The potential proprietary effect of the remedy of rescission lies in its restorative function. Where a contract or a transaction is vitiated by the unconscionable conduct, it is not sufficient that the aggrieved party is theoretically restored to his former position. The aggrieved party must be restored to that position in practical terms.<sup>43</sup> Indeed, if this cannot be achieved, then the remedy of rescission is not available.<sup>44</sup> But courts have taken a pragmatic and flexible attitude towards this requirement particularly when there is some form of unconscionable conduct.<sup>45</sup>

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<sup>38</sup> *Erlanger v The New Sombrero Phosphate Co* (1878) 3 App Cas 1218, 1278 (Lord Blackburn); *A H McDonald & Co Pty Ltd v Wells* (1931) 45 CLR 506, 512 (Rich, Starke and Dixon JJ); Meagher, Gummow and Lehane, above n 12 [2403]; Proksch, above n 12, [2501].

<sup>39</sup> Worthington, above n 3, 163-165. Note also Wright, above n 27, [3.67]-[3.79].

<sup>40</sup> Ibid 164-165.

<sup>41</sup> Ibid 165-167.

<sup>42</sup> Chapter 3, 122-127; Chapter 4, Part III.

<sup>43</sup> See for example, *Cooper v Phibbs* (1867) LR 2 HL 149; *Stepney v Biddulph* (1865) 12 LT 176; *Brown v Smitt* (1924) 34 CLR 160; *Solle v Butcher* [1950] 1 KB 671; *Evans v Benson & Co* [1961] WAR 12; *Mihaljevic v Eiffel Tower Motors Pty Ltd and General Credits Ltd* [1973] VR 545; *O'Sullivan v Management Agency & Music Ltd* [1985] QB 428.

<sup>44</sup> *Gans v Riley* (1913) 15 CLR 731; *AH McDonald & Co Pty Ltd v Wells* (1931) 45 CLR 506; *Drozd v Vaskas* [1960] SASR 88; *Holder v Holder* [1968] Ch 353; *Sargent v Campbell* [1972-73] ALR 708.

<sup>45</sup> Proksch, above n 12, [2511]; *Erlanger v The New Sombrero Phosphate Co* (1878) 3 App Cas 1218, 1278-1279 (Lord Blackburn).

This has ensured wrongdoers are not able to rely on practical impediments in order to avoid the rescission of a transaction. This same approach should be adopted in relation to insolvents who have acted unconscionably, as defined in Chapter 6. The fact that the wrongdoer is insolvent should not bar the creditor from effective proprietary relief.

In addition to the uncertainty whether rescission has proprietary effects, the remedy has other associated difficulties. Rescission does not operate automatically. A party must perform an act of rescission<sup>46</sup> and in some cases, a court order is required to revest title back to the innocent party.<sup>47</sup> Apparently, without such acts or court orders, the innocent party has no effective interest in the assets of the wrongdoing insolvent. No doubt, such a process is predicated on the basis that the contract is voidable. From the perspective of insolvency, the process is cumbersome.

#### **4 The Trust**

Although there are dangers in referring to a unitary concept of the trust in legal discussion,<sup>48</sup> what is considered here is the operation of the trust as a remedial response to unconscionable conduct. Both the constructive trust<sup>49</sup> and the resulting trust<sup>50</sup> have been put forward as appropriate proprietary devices to remedy unconscionable conduct (or unjust enrichment in actions in restitution). However, despite their different origins, after they come into existence, they operate in accordance with the fundamental characteristics of the standard trust model.<sup>51</sup> There is a division between legal title and equitable title of the subject property which is

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<sup>46</sup> *Abram Steamship Co Ltd v Westville Shipping Co Ltd* [1923] AC 773, 781 (Lord Atkinson); *Alati v Kruger* (1955) 94 CLR 216, 224 (Dixon CJ, Webb, Kitto and Taylor JJ).

<sup>47</sup> Proksch, above n 12, [2507], [2509].

<sup>48</sup> See generally RP Meagher and WMC Gummow, *Jacobs' Law of Trusts in Australia* (6<sup>th</sup> ed, 1997), Chapter 3; HAJ Ford and WA Lee, *Principles of the Law of Trusts* (3<sup>rd</sup> ed, 1996) [1110]-[1140]; DWM Waters, *Law of Trusts in Canada*, (2<sup>nd</sup> ed, 1984), Chapter 2.

<sup>49</sup> See *Muschinski v Dodds* (1985) 160 CLR 583; *Pettikus v Becker* [1980] 2 SCR 834; (1980) 117 DLR (3d) 257.

<sup>50</sup> See generally Robert Chambers, *Resulting Trusts* (1997) 220-230.

<sup>51</sup> Meagher and Gummow, above n 48, [105]-[110]; JD Heydon and PL Loughlan, *Cases and Materials on Equity and Trusts* (5<sup>th</sup> ed, 1997) [22.3.1]-[22.3.2].

vested in parties designated respectively as a trustee and a beneficiary.<sup>52</sup> Moreover, the trust operates over certain property which is defined or, in practical terms, is capable of being ascertained.<sup>53</sup> Thirdly, the trustee owes fiduciary obligations and these fiduciary obligations are annexed to the trust property.<sup>54</sup>

The trust is an effective mechanism. Despite the fact that a trustee holds the legal title to property, the division of the ownership of trust property results in the withdrawal of the trust property from the asset base of the trustee.<sup>55</sup> The operation of the trust is specifically recognised in insolvency legislation.<sup>56</sup> When interpreting such provisions, courts have not only included express trusts but also trust-like relationships.<sup>57</sup> Therefore, it is not surprising that courts have characterised relationships as being trust like and imposed the 'constructive' trust. In so doing, a court simultaneously vests equitable title in the aggrieved party and removed the property from distribution amongst unsecured creditors.

However, despite its effectiveness, the trust model is not the most appropriate proprietary response to unconscionable conduct where money is the subject of dispute.

First, certainty of subject matter is still a practical problem where money is concerned - although courts have taken a flexible and practical attitude towards certainty of subject matter where a trust has been mutually intended by the parties or where the money is capable of being traced.<sup>58</sup> Even where a flexible approach is taken in response to unconscionable conduct, the issue is what property should constitute trust property. There are three possible solutions. It is arguable that a trust

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<sup>52</sup> See for example Meagher and Gummow, above n 48, [105] and [107]; Waters, above n 48, 10-12.

<sup>53</sup> *Knight v Knight* (1840) 3 Beav 148; 49 ER 58; *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669, 705 (Lord Browne-Wilkinson); Meagher and Gummow, above n 48, [106].

<sup>54</sup> Meagher and Gummow, above n 48, [110]; Heydon and Loughlan, above n 51, [22.3.2].

<sup>55</sup> Waters, above n 48, 13-14.

<sup>56</sup> *Bankruptcy Act 1966* (Cth) s116 (2) (a).

<sup>57</sup> Dennis Rose, *Lewis: Australian Bankruptcy Law* (10<sup>th</sup> ed, 1994), 139; PP McQuade & MGR Gronow, *Australian Bankruptcy Law & Practice* (5<sup>th</sup> ed, 1996) vol 1, [116.2.05]-[116.2.63].

<sup>58</sup> Chapter 4, 137, 141-142.

arises in respect of property which the insolvent holds and which is of a similar nature to the former trust property. In the case of money, there would be no difficulty because a trust could arise over an equivalent amount. However, it would be difficult, if not impossible, to provide reasoned criteria as to which portion of money constitutes trust property. Another approach would be to argue that as the money in its original, mixed or substituted form no longer exists in accordance with traditional following and tracing rules, a trust arises over part of the insolvent's assets for the amount in dispute. Again, it would be difficult to provide reasoned criteria for the imposition of a trust over certain assets in preference to others - particularly where a monetary claim is involved. Finally, it is arguable that a trust could arise over the whole of the assets of the insolvent. In this case, the trust would vest the aggrieved creditor with an equitable interest in the entire assets of the insolvent until the creditor is paid out. This would effectively mean that the creditor would rank in priority over all unsecured (and, possibly all or some other secured creditors). Although the remedy would be highly effective from the creditor's point of view, it is likely that it would be extremely draconian from the perspective of the insolvent and the insolvent's secured creditors. Such a remedy may be completely disproportionate to the amount in dispute and the unconscionable conduct involved.

Secondly, if the trust is linked to specific property (as distinct from the general assets of the insolvent) then the value of the creditor's interest is directly linked to the underlying value of that property. Traditionally, where property is held on trust, the monetary or market value of the trust assets is determined by the actual property held on trust. It is submitted that it is possible to provide proprietary relief without any of this inherent danger.

Thirdly, equity imposes stringent duties and obligations upon the person who is designated as the trustee.<sup>59</sup> Trustees owe fiduciary obligations<sup>60</sup> and are debarred from dealing with property for their own benefit.<sup>61</sup> They are required to act with reasonable care<sup>62</sup> and loyalty.<sup>63</sup> Trustees are also regulated by legislation.<sup>64</sup> In the

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<sup>59</sup> See Meagher and Gummow, above n 48, [1602]-[1606] and Chapter 17; Ford and Lee, above n 48, Chapter 9; Waters, above n 48, Chapters 18-19.

<sup>60</sup> Chapter 2, 61-62.

<sup>61</sup> Meagher and Gummow, above n 48, [1742]; [1749]; Ford and Lee, above n 48, [9110]-[9120]

<sup>62</sup> Meagher and Gummow, above n 48, [1718]. Ford and Lee, above n 48, [9050]-[9060].

<sup>63</sup> Ford and Lee, above n 48, [9080].

light of these onerous duties which accompany trusteeship, the trust is not an appropriate response to unconscionable conduct in many instances where what is required is a device which elevates a party to the status of a secured creditor.

Fourthly, some commentators have argued that although the remedial response to unconscionable conduct is characterised as a constructive trust, it is not a trust. Referring to the operation of the constructive trust as a response to unjust enrichment, Waters has stated that:

an unjustly enriched person does not 'become a trustee,' as we understand that term in the law of express trusts. He will be required to hold the property in question for another, as an express trustee, too, must do. But chalk and cheese are not the same substance, even though they may happen to have the same colour. The similarities are truly accidental. To follow this further, an express trustee must recognise the claims of others, as indeed he must discharge a number of duties in his role of managing property on behalf of others. The unjustly enriched party is required to make specific restitution of that which he ought to restore to another. We may call this the duty to admit another's claim, if we will, provided we understand we are merely describing the effect of imposing upon him the obligation to restore what he should not have, and enforcing that obligation through the availability of a restitutionary remedy.<sup>65</sup>

Generally, courts do not wish to impose trust obligations upon the insolvent other than that the insolvent holds the property for another party.

Notwithstanding the onerous duties which accompany trusteeship, there are two cases where the imposition of a trust is warranted. The first situation is where a constructive trust is imposed in response to breach of pre-existing trust and/or fiduciary obligation. Traditionally, this has been called the institutional constructive trust.<sup>66</sup> Even where a constructive trust is imposed on third parties by virtue of the rules contained in *Barnes v Addy*,<sup>67</sup> it is imposed in order to support the efficacy of the pre-existing fiduciary obligation.

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<sup>64</sup> For example *Trustee Act 1925* (UK); *Trustee Act 1925* (NSW); *Trustee Act 1958* (Vic); *Trustee Act 1973* (Qld); *Trustee Act 1962* (WA); *Trustee Act 1936* (SA); *Trustee Act 1898* (Tas).

<sup>65</sup> Waters, above n 48, 388.

<sup>66</sup> Chapter 2, 65.

<sup>67</sup> (1874) LR 9 Ch App 244; See also Chapter 2, 64.

The other situation where a constructive trust is appropriate is where an aggrieved creditor establishes that an insolvent has acted unconscionably in the acquisition of an asset in which the creditor has a legitimate interest. In *Muschinski v Dodds*,<sup>68</sup> the facts of which are considered elsewhere,<sup>69</sup> it was clear that the woman wished to re-acquire the beneficial interest in specific property. Mason and Deane JJ held that it was unconscionable for the man to retain his legal entitlement to the property. They held that the man held his half share of the property on trust to repay the woman for the contribution she made to the acquisition of the property on his behalf.<sup>70</sup>

However, where there was no pre-existing trust operating and the underlying property which is subject to dispute is money (operating as a negotiable and functional commodity), then the trust is an unnecessary and inappropriate response to unconscionable conduct. Instead, the equitable lien, modified to take into account modern conditions, is more suited to the task.

### **III THE EQUITABLE LIEN - A REMEDY FOR THE 21ST CENTURY ?**

#### ***A Introduction***

In Chapter 4, it was suggested that we are evolving from a legal regime based on the need for a proprietary base, to a regime based on proprietary responses to unconscionable conduct. It is contended that, in the light of the negotiability and transactional ephemerality of money, the equitable lien will become an increasingly important remedial device where commercial risk is not assumed by an unsecured creditor.

Both common law and equity have developed a jurisdiction in which the lien was utilised. In common law, under a possessory lien, a creditor was entitled to retain the debtor's goods until the debt owing to the creditor was paid. The common law lien expanded into two kinds of possessory lien - a particular possessory lien and

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<sup>68</sup> (1985) 160 CLR 583.

<sup>69</sup> Chapter 5, 190.

<sup>70</sup> (1985) 160 CLR 583, 599 (Mason J); 620-624 (Deane J).



a general possessory lien.<sup>71</sup> Under the former, the creditor has the right to retain goods until the debt directly associated with those goods is paid.<sup>72</sup> Under the latter, the creditor has the right to retain goods until payment of all debts which are owed to him.<sup>73</sup> Common law liens are created by virtue of a common law right,<sup>74</sup> express agreement<sup>75</sup> or by statute.<sup>76</sup>

Common law liens appear to have been the dominant definitional form of lien in our legal system. The concept of lien is defined in *The Shorter Oxford English Dictionary*<sup>77</sup> from material from 1531 as

A right to retain possession of property until a debt due to the person detaining it is satisfied.<sup>78</sup>

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<sup>71</sup> See generally, JHG Sunnucks, 'Lien' in Lord Hailsham of St Marylebone (ed), *Halsbury's Laws of England* (4<sup>th</sup> ed, 1979) vol 28, [516]-[541].

<sup>72</sup> *Jones v Tarleton* (1842) 9 M&W 675; 152 ER 285.

<sup>73</sup> In relation to general liens in favour of solicitors see *Cowell v, Simpson* (1809) 16 Ves 275, 280; 2 Ves Jun Supp 441; 33 ER 989, 991 (Lord Eldon); 34 ER 1170; *Hughes v Hughes* [1958] 3 All ER 179; bankers; *Brandao v Barnett* (1846) 12 CL and Fin 787; 8 ER 1622; *London Chartered Bank of Australia v White* (1879) 4 App Cas 413; stockbrokers; *Jones v Peppercorne* (1858) John 430; 70 ER 490; *Re London and Globe Finance Corporation* [1902] 2 Ch 416; *John D Hope and Co v Glendinning* [1911] AC 419.

<sup>74</sup> In relation to bankers and solicitors, *ibid*.

<sup>75</sup> *Green v Farmer* (1768) 4 Burr 2214, 2221; 98 ER 154, 158 (Lord Mansfield); *Houghton v Matthews* (1803) 3 Bos & Pul 485, 494; 127 ER 263, 268 (Heath J); *Kirchner, Sharp and Waterston v Venus* (1859) 12 Moo 261; 14 ER 948; *Bock v Gorrisen* (1860) 2 De G F & J 434, 443; 45 ER 689, 693 (Lord Campbell); *Jowitt & Sons v Union Cold Storage Co* [1913] 3 KB 1; *United States Steel Products Co v Great Western Railway Co* [1916] 1 AC 189, 196 (Lord Buckmaster).

<sup>76</sup> For a discussion of workers liens in various jurisdictions see Ronald Donovan Elliot, *The Artificers Lien* (1967); John Nigel Wilson, *Contractors Liens and Charges* (1976); Douglas N Macklem and David I Bristow, *Construction and Mechanics Liens in Canada* (5<sup>th</sup> ed, 1985); Kevin Patrick McGuinness, *Constructive Lien Remedies in Ontario* (1983).

<sup>77</sup> William Little, HW Fowler and Jessie Coulson, *The Shorter Oxford English Dictionary* (3<sup>rd</sup> ed, 1973) vol 1.

<sup>78</sup> *Ibid* 1208; For similar trends see also JA Simpson and ESC Weiner, *The Oxford English Dictionary* (1989) vol VIII, 907; J M Sinclair (General Consultant), *Collins English Dictionary* (3<sup>rd</sup> ed, 1992) 899 and Virginia S Thatcher (ed), *The New Webster Encyclopedic Dictionary of the English Language* (1971) 491.

However, the common law lien is not an appropriate remedial response to unconscionable conduct because the party claiming the lien has the property subject to the lien in his possession. In the factual scenarios and cases which have been raised throughout the thesis show that this has not been the case.

### ***B The Equitable Lien***

A modern definition of the equitable lien is:

‘Equitable lien’ means an equitable right, conferred by law upon one person, to a charge upon the real or personal property of another until certain specific claims have been satisfied...An equitable lien differs from a common law lien in that a common law lien is founded on possession and, except as modified by statute, merely confers a right to detain the property until payment, whereas an equitable lien, which exists quite irrespective of possession confers on the holder the right to a judicial sale.<sup>79</sup>

It is not a possessory lien. It arises irrespective of whether the party claiming the lien has possession of the disputed goods or money. It also operates without the necessity that the parties have an intention to create it. A lien which does arise by virtue of intention of the parties is called a charge, in order to distinguish it from a lien, which arises irrespective of intention.<sup>80</sup> The equitable lien is an equitable mechanism which has the potential for great flexibility because it can arise in response to unconscionable conduct and provide security over assets in the hands of the insolvent.

### ***C The Equitable Lien and the Trust***

The equitable lien differs from the express trust in that it may arise without the necessity of the parties having an intention to create it. In this respect, an equitable lien appears similar to a constructive trust and a resulting trust.<sup>81</sup>

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<sup>79</sup> Sunnucks, above n 71, [551].

<sup>80</sup> Edward I Sykes and Sally Walker, *The Law of Securities* (5<sup>th</sup> ed, 1993) 193-199.

<sup>81</sup> See *Fulp v Fulp* 140 SE (2d) 708 (SC North Carolina, 1965); *Minton v Stewart* 359 SW (2d) 925 (Court of Civil Appeal Texas, 1962); *Holder v Williams* 334 P (2d) 291 (District Court of Appeal, California, 1959) 292-293; CJS Liens § 1, 832.

However, a lienee acquires different rights than a beneficiary under a trust. Generally, a beneficiary acquires a vested equitable interest and rights in respect of the administration of the trust as well.<sup>82</sup> Without a separation of the legal and equitable interests, there is no trust.<sup>83</sup> However, under a lien, the lienee does not acquire an equitable interest in property. Pomeroy states:

In an equitable lien there is a legal estate with possession in one person, and a special right *over* the thing held by another; but here the resemblance, which at most is external, ends. This special right is not an *estate* of any kind; it does not entitle the holder to a conveyance of the thing nor to its use; it is merely a right to secure the performance of some outstanding obligation, by means of a proceeding directed against the thing which is subject to the lien. To call this a trust, and the owner of the thing a trustee for the lien-holder, is a misapplication of terms which have a very distinct and certain meaning.<sup>84</sup>

The security interest acquired by a lienee has a number of significant consequences for the operation of the lien.

First, because the equitable lien does not provide the lienee with an equitable interest, the value of the lien is not tied to the underlying value of the property upon which the lien is fixed. In contrast, a beneficiary has an equitable interest in property which will be fixed to the value of the property of the trust. Therefore, where the underlying property appreciates, it has been opportune to argue that a trust regulates the relationship. On the other hand, where the underlying property has depreciated, parties have argued that a lien has arisen.<sup>85</sup>

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<sup>82</sup> Meagher and Gummow, above n 48, [2303]-[2306]; cf discretionary trusts: *Gartside v Inland Revenue Commissioners* [1968] AC 553; IJ Hardingham and R Baxt, *Discretionary Trusts* (2<sup>nd</sup> ed, 1984) [605]-[609].

<sup>83</sup> *Re Cook; Beck v Grant* [1948] Ch 212; *Re Haberley, dec'd* [1971] NZLR 325; *DKLR Holding Co (No 2) Pty Ltd v CSD (NSW)* (1982) 40 ALR 1; *Re Transphere Pty Ltd* (1986) 10 ACLR 726; Waters, above n 48, 10-13.

<sup>84</sup> Spencer W Symons, *John Norton Pomeroy: A Treatise of Equity Jurisprudence*, (5<sup>th</sup> ed, 1941) Vol IV, § 1234 (fn 5); American Law Institute, *Restatement of the Law Second, Restitution, Tentative Draft No 2* (1984) § 30a.

<sup>85</sup> DWM Waters, *The Constructive Trust: The Case for a New Approach in English Law* (1964) 27 and Frank R Lacy, 'Constructive Trusts and Equitable Liens in Iowa' (1954-1955) 40 *Iowa Law Review* 107, 145-155 and the cases discussed therein and Malcolm Cope, *Proprietary Claims and Remedies* (1997) 112.

Secondly, a beneficiary is entitled to the income of the underlying property.<sup>86</sup> Conversely, a lienee is not entitled to the product or income produced by the underlying property.<sup>87</sup>

Thirdly, it has been suggested that the equitable lien cannot be sustained outside the limitations period set by statute.<sup>88</sup>

Fourthly, a trustee has far more onerous duties in relation to the underlying property than does the lienor.<sup>89</sup> This highlights the very different historical origins and functions of the trust and the lien. The equitable lien is discussed by authors as part of the modern law of securities,<sup>90</sup> whilst the trust is not generally considered as a security device.<sup>91</sup> The lien operates as a bare security. In comparison, the trust operates as a security interest coupled with burdensome obligations. There is a place and need for both in our legal systems. The problem has been that the trust and the equitable lien have been confused and misunderstood.

Finally, a difference between the constructive trust and the lien is that the lien has been available in discrete circumstances only,<sup>92</sup> whilst the constructive trust has, at least recently, been the subject of some judicial creativity. The constructive trust has been a remedial response to unconscionable conduct (and unjust enrichment) although the situations where the constructive trust would be available, remains to be developed.<sup>93</sup> Whilst the equitable lien is still highly relevant to the kinds of situations

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<sup>86</sup> Lacy, above n 85, 145-152.

<sup>87</sup> Ibid.

<sup>88</sup> Sunnucks, above n 71, [551] noting *the Limitation Act 1939* (UK) s 18(1).

<sup>89</sup> *Lord Napier and Ettrick v Hunter* [1993] AC 713, 738 (Lord Templeman).

<sup>90</sup> Sykes and Walker, above n 80, 199-206.

<sup>91</sup> Ibid 12.

<sup>92</sup> PV Baker and P St J Langan, *Snell's Equity* (29<sup>th</sup> ed, 1990) Chapter 10.

<sup>93</sup> See for example *Muschinski v Dodds* (1985) 160 CLR 583; *Pettkus v Becker* [1980] 2 SCR 834; (1980) 117 DLR (3d) 257; *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669, 716 (Lord Browne-Wilkinson); M Cope *Constructive Trusts* (1992) Chapters 1 and 2.

where it has traditionally operated, it is beginning to be disentangled from the limited traditional applications in the past.<sup>94</sup>

In order to understand the lien and the reasons why it has not been utilised freely as a security device in response to unconscionable conduct, it is necessary to consider its origins and function in our legal system.

### ***D The Origins of the Equitable Lien***

Despite suggestions that the lien stems from the decision of the Courts of Chancery in the 1800s,<sup>95</sup> the origins of the equitable lien appear to lie in Roman law which was well known to English lawyers. Roman law developed a number of securities over property, including the *hypotheca*, which were adopted in 19th century England.<sup>96</sup>

The Roman *hypotheca* originated as a response to the inconsistencies which arose from the use of other forms of available security.<sup>97</sup> The *hypotheca* arose by pledging the item without the need for its physical transfer to the creditor.<sup>98</sup> Sykes and Walker have stated:

In the third general class of security (*hypotheca*), the arrangement of rights is more subtle than in the case of the other two. The property is appropriated to the creditor so that on default he or she is entitled to pursue certain remedies against it and not merely against the debtor. The creditor has certain rights of a proprietary character, but they can be realised only in the event of default. To this general type of security the term 'charge' is frequently applied, but that phrase is itself of ambiguous import and is better used to denote one particular type of hypothecation.<sup>99</sup>

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<sup>94</sup> Barbara E Cotton, 'The Equitable Lien: New Life in an Old Remedy?' [1994] 16 *Advocate's Quarterly* 385.

<sup>95</sup> *Ibid* 385.

<sup>96</sup> Note the consideration and discussion of Roman law in *Ryall v Rowles* (1750) 1 Ves Sen 349, 358; 27 ER 1074, 1081 and generally WB Buckland, *Equity in Roman Law* (1911).

<sup>97</sup> HF Jolowicz, *Historical Introduction to the Study of Roman Law* (1952) 319.

<sup>98</sup> RW Lee, *The Elements of Roman Law* (4<sup>th</sup> ed, 1956) [261]-[265]; Jolowicz, above n 97, 319.

<sup>99</sup> Sykes and Walker, above n 80, 14.

Whilst legal historians have disputed the origins of the *hypotheca*,<sup>100</sup> it presaged the development of modern securities which did not require possession - most notably the mortgage<sup>101</sup> and the equitable lien.<sup>102</sup> The *hypotheca* was capable of being created by the agreement of the parties.<sup>103</sup> However, there was also the legal or *tacit hypotheca* (or *hypotheca tacita* or *legitima*). These *hypotheca* were created by law.<sup>104</sup> In turn, the *tacit hypotheca* was divided into two kinds. The special *hypotheca* was potentially, a security imposed by law over specific property.<sup>105</sup> The general *hypotheca* was a charge over the whole of the debtor's property to secure liability.<sup>106</sup> Modern comparisons have been noted. Thomas has stated:

Though generally used for land, hypothec (sic) could be utilised to create a security over any form of *res*, including debts; indeed, there was possible the equivalent of the 'floating charge' of English law, ie, a lien on the debtor's stock-in-trade for the time being; anything that could be the object of a sale could be pledged or hypothecated.<sup>107</sup>

Early predecessors of the common law lien were in operation during the medieval and tudor periods.<sup>108</sup> However, in contrast it appears that the *hypotheca* was lost, or nearly lost, even though the notion of a non-possessory security was clearly evident in medieval times.<sup>109</sup> The logical answer may be that what had been labelled an

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<sup>100</sup> Compare and contrast Barry Nicholas, *An Introduction to Roman Law* (1962) 152; Rudolph Sohm, *The Institutes: A Textbook of the History and System of Roman Private Law* (3<sup>rd</sup> ed, 1907), 354-355; Jolowicz, above n 97, 319-320; JAC Thomas, *Textbook of Roman Law* (1976), 332; Lee, above n 98, [261].

<sup>101</sup> Charles Phineas Sherman, *Roman Law in the Modern World* (1917) vol 2, § 616.

<sup>102</sup> Ibid.

<sup>103</sup> Lee, above n 98, [261]; Jolowicz, above n 97, 319.

<sup>104</sup> Lee, above n 98, [263]; DH Van Zyl, *History and Principles of Roman Private Law* (1983) 199.

<sup>105</sup> Lee, above n 98, [263].

<sup>106</sup> For an example of the general *hypotheca* see Lee, above n 98, [263]; Van Zyl, above n 104, 199; Nicholas, above n 100, 152-153.

<sup>107</sup> Thomas, above n 100, 332. See also Buckland, above n 96, 63-71; Jairus W Perry (ed), *Joseph Story: Commentaries on Equity Jurisprudence as Administered in England and America* (13<sup>th</sup> ed, 1877) vol II, §1221-1224.

<sup>108</sup> William Holdsworth, *A History of English Law* (2<sup>nd</sup>, ed, 1937) vol 7, 511-513.

<sup>109</sup> Sir Frederick Pollock and Frederic William Maitland, *The History of English Law Before the Time of Edward I* (2<sup>nd</sup> ed, 1968) vol II, 117-118.

*hypotheca* in Roman law was then called something quite different in medieval English law. After all, no explanation has been found as to why the offspring of the Roman *hypotheca* became known as a lien. Perhaps, after the Norman Invasion non-possessory securities were known according to a French nomenclature and the Law French.<sup>110</sup> In *The Oxford English Dictionary* the word lien is given both a French and a Latin derivation.<sup>111</sup>

It is probable that the modern equitable lien grew out of the common law notion of lien in response to mercantile needs during the 18th and 19th Centuries. The development of the equitable lien was apparent<sup>112</sup> but slow. For example, Blackstone<sup>113</sup> did not discuss the equitable lien but was aware of the existence of the *pignus* and *hypotheca* as Roman law security devices which he briefly mentioned in the context of mortgages.<sup>114</sup> Prior to and during the 18th century there was some case law which confirmed the legitimacy of the vendor's equitable lien over the land for the purchase price<sup>115</sup> and the trustee's lien.<sup>116</sup> Later, well into the 18th century, it seems that the purchaser's lien<sup>117</sup> and the partnership lien<sup>118</sup> appeared. In the 19th century, the equitable lien had a sustained application. There are numerous cases which deal with, in one way or another, the vendor's equitable lien,<sup>119</sup> the purchaser's

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<sup>110</sup> Bryan A Garner, *A Dictionary of Modern Usage* (2<sup>nd</sup> ed, 1995) 504-505.

<sup>111</sup> Simpson and Weiner, above n 78, vol VIII, 90.

<sup>112</sup> Note *Ryall v Rowles* 1 Ves Sen 348; 27 ER 1074 and Charles Viner, *A General Abridgment of Law and Equity* (1743) vol 15, 96-99 (lien on lands) and vol 4, 449-476 (charge).

<sup>113</sup> William Blackstone, *Commentaries on the Laws of England* (1764).

<sup>114</sup> Ibid Vol II, 159. Note also Viner, above n 112, vol 14 329-331 (hypothecations in relation to maritime vessels); the definition of 'hypotheca' and 'to hypothecate' in Owen Ruffhead and J Morgan, *A New Law Dictionary*, (1772). For examples of texts which did not deal with the concept of hypothecation, charge or lien see *Precedents in Chancery. being a Collection of Cases Argued and Adjudged in the High Court of Chancery; From the Year 1689 to 1722* (1733); Henry Ballou, *A Treatise of Equity* (1737).

<sup>115</sup> *Hearle v Botelers* (1604) Cary 25; 21 ER 14; *Chapman v Tanner* (1684) 1 Vern 267; 23 ER 461; *Harrison v Southcote and Moreland* (1751) 2 Ves Sen 389; 28 ER 249.

<sup>116</sup> *How v Godfrey* (1678) Rep Temp Finch 361; 23 ER 198.

<sup>117</sup> *Burgess v Wheate, AG v Wheate* (1759) 1 Eden 177, 211; 28 ER 652, 665 (Lord Mansfield).

<sup>118</sup> *West v Skip* (1749) 1 Ves Sen 239; 27 ER 1006.

<sup>119</sup> *Mackreth v Symmons* (1808) 15 Ves Jun 328; 2 Ves Jun Supp 410; 33 ER 778; 34 ER 1155; *Lysaght v Edwards* (1876) 2 Ch D 499; *Kettlewell v Watson* (1884) 26 Ch D 501.

equitable lien,<sup>120</sup> partnership liens<sup>121</sup> and a trustee's right to be indemnified<sup>122</sup> In addition, Story identified the equitable lien as a remedy for mistaken improvements to land.<sup>123</sup>

The reason why the equitable lien remained a significant equitable mechanism during the 19th century in the atmosphere of laissez-faire capitalism<sup>124</sup> has not been authoritatively considered by legal historians. But some suggestions may be proffered. The equitable lien was the subject of indisputable 18th century precedent. The lien was applied in a circumscribed and uncreative way. In those 19th century texts which do deal with the equitable lien, the treatment is generally formalistic and cursory.<sup>125</sup> Moreover, where the law concerning trusts and partnerships was concerned, the equitable lien was being used in areas which were incontestably the province of equitable jurisdiction anyway.<sup>126</sup> Finally, the imposition of a lien in the seminal vendor and purchaser cases<sup>127</sup> did not detract from the enforcement of the contract. It assisted in the performance of the contract and

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<sup>120</sup> *Wythes v Lee* (1855) 2 Drewry 396; 61 ER 954; *Westmacott v Robins* (1864) 4 De GF & J 390; 45 ER 1234; *Rose v Watson* (1864) 10 HL Cas 672; 11 ER 1187; *Aberaman Ironworks v Wickens* (1868) 4 Ch App 101; *Rodger v Harrison* [1893] 1 QB 161.

<sup>121</sup> *Ex parte Williams* (1805) 11 Ves Jun 3; 32 ER 988; *Ex parte King* (1810) 17 Ves 115; 34 ER 45; *Kelly v Hutton* (1868) 3 Ch App 703; *Harvey v Crickett* (1816) 5 M & S 336; 105 ER 1074; *Hague v Dandeson* (1848) 2 Exch 741; 154 ER 689.

<sup>122</sup> *Dawson v Clarke* (1811) 18 Ves 247; 34 ER 311; *Batten, Proffitt and Scott v Dartmouth Harbour Commissioners* (1890) 45 Ch D 612; *Budgett v Budgett* [1895] 1 Ch 202.

<sup>123</sup> See Perry, above n 107, vol II, §1237. Note also 53 CJS Liens § 8b; 51 Am Jur 2d Liens §34; R J Sutton, 'What Should be Done for Mistaken Improvers' in PD Finn (ed), *Essays on Restitution*, (1990) 241.

<sup>124</sup> Chapter 1, 17-20; PS Atiyah, *The Rise and Fall of Freedom of Contract*, (1979) 393-397.

<sup>125</sup> See for example John Fonblanque, *A Treatise of Equity* (5<sup>th</sup> ed, 1820) vol 1, 232, 155, footnote (e), and 381, footnote (k); Thomas Lewin, *Practical Treatise on the Law of Trusts* (5<sup>th</sup> ed, 1867) 453, 454 and 508. The Right Honourable the Earl of Halsbury, *The Laws of England* (1911), Vol XIX, [20]-[39]; cf Perry, above n 107, vol I, § 506.

<sup>126</sup> For the role that equity developed the legal framework of partnership in the 18th and 19th Centuries see Keith L Fletcher, *Higgins and Fletcher: The Law of Partnership in Australia and New Zealand*, (7<sup>th</sup> ed, 1996) 6-7; Holdsworth, above n 108, vol 8, 217-218.

<sup>127</sup> See for example *Hearle v Botchers* (1604) Cary 35; 21 ER 14; *Chapman v Tanner* (1684) 1 Vern 267; 23 ER 461; *Harrison v Southcote and Moreland* (1751) 2 Ves Sen 389; 28 ER 249; *Burgess v Wheate*, *AG v Wheate* (1759) 1 Eden 177; 28 ER 652.



provided an additional equitable remedy where common law on its own was deficient.

## ***E Characteristics of the Application of the Equitable Lien in the 19th and 20th Centuries***

There were three features of the application of the equitable lien in the 19th century which have determined how it has operated in recent times.

### ***1 Redressing Unconscionable Conduct***

Despite the 19th century abhorrence of the discussion of policy issues,<sup>128</sup> in some cases courts still ventured to posit reasons for the imposition of the equitable lien. In *Todd v Moorhouse*<sup>129</sup> Jessel MR held that a tenant for life under a settlement comprising shares who had made an advance to a trustee had an equitable lien over the shares for repayment with interest. He said in relation to argument by counsel:

The proposition he [counsel] affirms is this, that if one of the *cestuis que trust* advances money for the purpose of paying a sum properly payable out of the *corpus* of the trust funds, then, unless it can be shown that the trustees could not raise the money in any other way, the person advancing his money is to lose it. That is, the *cestuis que trust* are to be enriched by the amount advanced merely because the trustees by some possible means or other could otherwise have raised that amount, and the *cestuis que trust* can, therefore, keep both the money advanced and the property which ought to have been sold to raise money. Common sense, common honesty, and sound law are altogether against any such extravagant notion.<sup>130</sup>

In 1902, Vaughan Williams LJ said that a purchaser's lien was 'a right which may have been invented for the purpose of doing justice.'<sup>131</sup>

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<sup>128</sup> PS Atiyah, above n 124, 388.

<sup>129</sup> [1874-75] XIX Equity Cas LR 69.

<sup>130</sup> Ibid 71. See also *Re Johnson; Shearman v Robinson* (1880) 15 LR Ch D 548, 555-556 (Jessel MR).

<sup>131</sup> *Whitbread & Co Ltd v Watt* [1902] 1 Ch 835, 838. See also *Rose v Watson* [1864] 10 HLC 672; 11 ER 1187. Note also in this context David M Wright, above n 27, [3.63]. For a discussion of the United States case law and unjust enrichment see American Law Institute, *Restatement of the Law*

In the United States, the equitable lien has been utilised with great effectiveness to redress many forms of unconscionable conduct where remedies at law would be inadequate and incomplete.<sup>132</sup> The kinds of situations where the equitable lien may arise are not closed.<sup>133</sup> But it would be a misrepresentation to say that the equitable lien is available simply on the basis of subjective discretion.<sup>134</sup>

Recent Anglo-Australian cases indicate that courts may increasingly use the equitable lien to redress unconscionable conduct outside traditional contexts.

**(a) *Hewett v Court***<sup>135</sup>

A builder of prefabricated houses agreed to pre-construct a house for a purchase and then transport the home to the purchaser for practical completion. The purchase price was payable in instalments. The first two payments were made by the purchasers. The builder became insolvent. The contract provided that the house remained the property of the builder until completion. The parties agreed that the purchasers would pay for the work undertaken and take the house in its incomplete state. A revised balance of what was outstanding was calculated and paid by the purchasers. After the variation of the agreement liquidators were appointed who argued that the purchasers had obtained a preference. The purchasers argued that they had an equitable lien over the house.<sup>136</sup>

The High Court decided by a majority of three (Gibbs CJ, Murphy and Deane JJ) to two (Wilson and Dawson JJ) that the purchasers had an equitable lien over the

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*Second, Restitution, Tentative Draft No 2* (1984), §30, comment b, 6; *Caldwell v Armstrong* 342 F (2d) 485 (10<sup>th</sup> Cir, 1965); *United States v Adamanti Co* 197 F (2d) 1 (9<sup>th</sup> Cir, 1952); 53 CJS Liens § 8; 51 Am Jur 2d Liens § 22-§ 35.

<sup>132</sup> Cotton, above n 94, 393 citing *Hill v Hill* 345 P (2d) 1015 (SC Kansas, 1959).

<sup>133</sup> *Gables Racing Association Inc v Persky* 6 So (2d) 257 (SC Florida, 1942), 262. (Justice Adams); 53 CJS Liens § 5.

<sup>134</sup> 53 CJS Liens § 5; 51 Am Jur 2d Liens § 24.

<sup>135</sup> (1983) 149 CLR 639; For a discussion of the case see Sykes and Walker, above n 80, 202, 205-206; IJ Hardingham, 'Equitable Liens for the Recovery of Purchase Money' (1985) 15 *Melbourne University Law Review* 65; Michael Christie, 'The Equitable Lien in a Commercial Context: Some Recent Australian Developments' (1986) 14 *Australian Business Law Review* 435.

<sup>136</sup> Note also the earlier decisions in *Court and Evans v Hewett* [1981] WAR 237 (Wickham J); *Court and Evans v Hewett* [1982] WAR 151 (CA).

house for the amount of the purchase money paid. The dissenting judges, Wilson and Dawson JJ, held that there was insufficient authority to warrant an equitable lien arising. When the first instalment was paid there was nothing to which the lien could attach.<sup>137</sup>

*Hewett v Court* was significant because a majority of the High Court were willing to accept that an equitable lien, a proprietary remedy, could arise outside established categories on the basis of redressing unconscionable conduct. Moreover, it would arise even though there was no direct nexus between the payments and the house. The majority of the High Court did not insist that the instalments were to be used for the construction of the house.<sup>138</sup> Rather, they simply required that the house in question was appropriated to the contract. In this context, the builder appropriated the house to the contract when the builder identified the house as the property built in satisfaction of the contractual obligation. The decision has been criticised.<sup>139</sup> But more farsighted authors praised the outcome of the majority judgments as a significant step towards the principled liberalisation of proprietary remedies.<sup>140</sup>

***(b) Lord Napier and Ettrick v Hunter***<sup>141</sup>

The basic facts are set out in Chapter 4.<sup>142</sup> The insured was insolvent. The House of Lords found that the doctrine of subrogation applied because it would be unconscionable for the insured to refuse to recoup the insurer.<sup>143</sup> Thereafter, the question was what was the appropriate remedy. Lord Templeman said:

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<sup>137</sup> (1983) 149 CLR 639, 656-658.

<sup>138</sup> *Ibid*, 648 (Gibbs CJ); 669-670 (Dean J) and 650 (Murphy J).

<sup>139</sup> Sykes and Walker, above n 80, 206; JC Starke, 'Current Topics' (1983) 57 *The Australian Law Journal* 433, 434-436.

<sup>140</sup> Donovan W M Waters, 'Where is Equity Going? Remedying Unconscionable Conduct' (1988) 18 *The University of Western Australia Law Review* 3, 32-41; Paul R Coughlan, 'Equitable Liens for the Recovery of Book Deposits' (1987) 9 *Dublin University Law Journal* 90, 95-98; IJ Hardingham, 'Equitable Liens for the Recovery of Purchase Money' (1985) 15 *Melbourne University Law Review* 65.

<sup>141</sup> [1993] AC 713.

<sup>142</sup> Chapter 2, 87-88; Chapter 4, 144-145.

<sup>143</sup> [1993] AC 713.

It is next necessary to consider how equity copes with such unconscionable conduct. Saville J and the Court of Appeal appear to have thought that equity can only interfere by creating a trust fund held in trust by trustees for different beneficiaries in different shares, the trustees being burdened with administrative and investment duties, the trustees being liable for all the duties imposed on trustees but being free from liability if the trust fund is lost without negligence. I agree that if this were the only method of protecting the rights of an insurer the practical disadvantages would be fearsome. Fortunately, equity is not so inflexible or powerless. In order to protect the rights of the insurer under the doctrine of subrogation equity considers that the damages payable by a wrongdoer to the insured person are subject to an equitable lien or charge in favour of the insurer. The charge is imposed by equity because the insurer, once he has paid under the policy, has an interest in the right of action against the wrongdoer and an interest in the establishment, quantification, recovery and distribution of the damages awarded against the wrongdoer. It would be unconscionable for the insured person, who has received £100,000 from the insurer, to put damages of £130,000 into his own pocket without providing for the recoupment of the insurer who only contracted to indemnify the insured person.<sup>144</sup>

Lord Goff agreed with Lord Templeman in this regard.<sup>145</sup> In making such a decision, the House of Lords effectively helped to make sense of those cases in which a trust was impressed on any compensation that an insured received from the wrongdoer.<sup>146</sup> The lien awarded in *Lord Napier and Ettrick v Hunter* has been praised as a viable security alternative to the trust.<sup>147</sup>

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<sup>144</sup> Ibid 738.

<sup>145</sup> Ibid 744-745.

<sup>146</sup> See SR Derham, *Subrogation in Insurance Law* (1985) 25 and the cases cited therein including *Randal v Cockran* (1748) 1 Ves Sen 98; 27 ER 916; *Blaauwpot v Da Costa* (1758) 1 Eden 130; 28 ER 633; *Commercial Union Assurance Co v Lister* (1874) LR 9 Ch App 483; *King v Victoria Insurance Co Ltd* (1896) AC 250; *Morely v Moore* [1936] 2 KB 359.

<sup>147</sup> WMC Gummow, 'Names and Equitable Liens' (1993) 109 *The Law Quarterly Review* 159, 163; cf Charles Mitchell, *The Law of Subrogation* (1994) 83.

## 2 Confusion of the Trust and the Equitable Lien

The equitable lien and the trust are still confused with each other. This phenomenon has gone largely unnoticed. Waters has argued that in the consideration of vendor and purchaser liens over land, judges in the 19th century often confused the concepts of equitable lien and trust.<sup>148</sup> The confusion of the trust and the lien was evident in a leading text of the time. In *Joseph Story: Commentaries on Equity Jurisprudence*<sup>149</sup> the equitable lien was discussed in the context of implied trusts,<sup>150</sup> even though it was clear that the author understood the difference between the equitable lien and the trust in proprietary terms.<sup>151</sup> Thus, the lien was portrayed as a minor part of the law of trusts and, as Waters has shown, when the lien was the appropriate device, judges often preferred to read the lien as a trust instead.<sup>152</sup> Certainly, in the seminal judgment of Jessel MR in *Re Hallett's Estate; Knatchbull v Hallett*,<sup>153</sup> the trust and the equitable lien (referred to incorrectly as a charge) were proffered as alternative remedies for breach of trust and fiduciary obligations.<sup>154</sup>

In the 20th century, the confusion of the lien and the trust is still evident. For example, in some works the equitable lien has been treated as synonymous with the constructive trust.<sup>155</sup> The constructive trust (rather than the equitable lien) has been seen as the proprietary remedy of a vendor under a contract for sale of land.

Nonetheless, in both the 19th and 20th Centuries, the lien as a security device has been utilised without the attendant obligations associated with the trust. Therefore, it is not surprising that the lien arises in legislative contexts in Canada and

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<sup>148</sup> Waters, above n 85, 85-86, 96-100, 131-136.

<sup>149</sup> Perry, above n 107, vol II.

<sup>150</sup> Ibid § 1216-1244; cf Symons, above n 84, vol IV, §1234.

<sup>151</sup> Ibid §1217.

<sup>152</sup> Waters, above n 85, 85-86; 96-100; 131-136.

<sup>153</sup> (1880) 13 Ch D 696.

<sup>154</sup> Ibid 709.

<sup>155</sup> See for example Cope, above n 93, Chapter 25; AJ Oakley, *Constructive Trusts* (3<sup>rd</sup>, ed, 1997) Chapter 6 and Jill E. Martin, *Hanbury and Maudsley: Modern Equity* (15<sup>th</sup> ed, 1997) 640-641.

Australia.<sup>156</sup> In Anglo-Australian law there are also special non-statutory and statutory maritime liens.<sup>157</sup> In American statutes, the lien, both in equity and common law, has been used with great effectiveness.<sup>158</sup>

### 3 Liens over Specific Property

In the 19th and 20th Centuries the lien has operated as a charge over specific property. The nature of the lien (rather than the events which triggered it) is akin to the Roman law tacit special *hypotheca* where a charge over specific property was imposed by law. In *Hewett v Court*,<sup>159</sup> Deane J said that a lien arose only where property could be specifically identified as subject to the lien.<sup>160</sup> This requirement is also evident in the United States.<sup>161</sup> This was justifiable where land was concerned,<sup>162</sup> but it is unworkable where money and fungibles are involved.

Yet, in hindsight, it is arguable that the 19th century judges and lawyers also had the opportunity to adopt a lien akin to the general tacit *hypotheca*. Such a lien would not require the identification of specific property or the segregation and reification of money. Although 19th century judges explicitly refused to countenance

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<sup>156</sup> For a discussion of Canadian statutory liens see Douglas N Macklem and David I Bristow, *Construction and Mechanics' Liens in Canada*, (1985) Chapters 2 and 3. For a general discussion of statutory hypothecations in Australia see Sykes and Walker, above n 80, 750-752. In relation to liens in colonial times see Alex C Castles, *An Australian Legal History* (1982) 172-175.

<sup>157</sup> For a discussion of the Australian position see Sykes and Walker, above n 80, 753-758; DA Butler and WD Duncan, *Maritime Law in Australia* (1992) particularly [3.3.2]. For a discussion of the English position see DR Thomas, *Maritime Liens* (1980).

<sup>158</sup> See 53 CJS Liens § 9 and 51 Am Jur 2d Liens § 36-§39.

<sup>159</sup> [1983] 149 CLR 639.

<sup>160</sup> Ibid 668.

<sup>161</sup> American Law Institute, *Restatement of the Law Second, Restitution, Tentative Draft No 2* (1984) § 30g.

<sup>162</sup> See *Hearle v Botelers* (1604) Cary 25; 21 ER 14; *Chapman v Tanner* (1694) 1 Vern 267; 23 ER 461; *Mackreth v Symmons* (1808) 15 Ves Jun 329; 2 Ves Supp 410; 33 ER 778; 34 ER 461; *Lysaght v Edwards* (1876) 2 Ch D 499; *Kettlewell v Watson* (1884) 26 Ch D 501; *Burgess v Wheate; Attorney-General v Wheate* (1759) 1 Eden 177; 28 ER 652; *Westmacott v Robins* (1864) 4 De GF & J 390; 45 ER 1234; *Rose v Watson* (1864) 10 HL Cas 672; 11 ER 1197; *Aberaman Ironworks v Wickens* (1868) 4 Ch App 101.

the fully fledged development of the lien as a hypothecation in common law,<sup>163</sup> equity provided impetus in one area for the general lien - the floating charge.

### ***(a) The Floating Equitable Charge***

The modern corporation was a product of 19th century mercantile developments.<sup>164</sup> It was quickly discovered that the corporate asset base was neither stable nor specific.<sup>165</sup> The problem was how could security be provided over fluctuating assets. Gough<sup>166</sup> has pointed out that by the mid-19th century there was a specific equitable charge available over specific corporate property.<sup>167</sup> The development of the specific company charge was, no doubt, inspired by developments in the law of real property. During this period Torrens advocated the Torrens title mortgage<sup>168</sup> which operates as a security without the need for the transfer of ownership.<sup>169</sup>

According to Gough's analysis, the floating equitable charge was born in the 1870s.<sup>170</sup> Prior to that time, the Court of Chancery was unable to countenance the existence of a floating security.<sup>171</sup> But, spurred on by developments in equity

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<sup>163</sup> *Howes v Ball* (1827) 7 B & C 481, 484; 108 ER 802, 804 (Lord Tenterden CJ). *Donald v Suckling* (1866) LR 1 QB 585, 613 (Blackburn J); *Sewell v Burdick* (1884) 10 App Cas 74, 95-96 (Lord Blackburn).

<sup>164</sup> For a historical discussion see Paul L Davies, *Gower's Principles of Modern Company Law* (6th ed, Sweet & Maxwell, 1997) Chapters 2 and 3.

<sup>165</sup> HAJ Ford, RP Austin and IM Ramsay *Principles of Corporations Law* (8th ed, 1997) [1.320].

<sup>166</sup> William James Gough, *Company Charges* (2nd ed, 1996).

<sup>167</sup> Gough, above n 166, 27-28; *Brown v Bateman* (1867) LR 2 CP 272.

<sup>168</sup> Douglas J Whalan, *The Torrens System in Australia*, (1982), 167-168; Robert TJ Stein and Margaret A Stone, *Torrens Title* (1991) 165-166.

<sup>169</sup> *CL Forrest Trust: Trustees Executors and Agency Co Ltd v Anson* [1953] VLR 246, 256 (Herring CJ). See also *The English Scottish and Australian Bank Ltd v Phillips* (1937) 57 CLR 302, 321-322 (Dixon, Evatt and McTiernan JJ).

<sup>170</sup> Gough, above n 166, 102-108.

<sup>171</sup> *King v Marshall* (1864) 33 Beav 565; 55 ER 488; *New Clydach Street and Bar Iron Co* (1868) LR 6 Eq 514.

allowing a party to assign future property,<sup>172</sup> the floating charge developed in a series of important cases starting with *Re Panama; New Zealand and Australian Royal Mail Co.*<sup>173</sup> The floating charge was justified on the basis that it avoided the paralysis of the company's business operations. Otherwise, the consent of the creditor would be necessary each time the company wished to dispose of an asset.<sup>174</sup> The floating charge was (and is) created by the contractual and mutual intention of the parties to charge the company's asset as a going concern.<sup>175</sup>

The floating charge was not only a security over the whole of the assets of the chargor. It also secured assets which became part of the corporate asset base *after* the execution of the charge documentation. Hence the charge was both general and floating. It was only upon default that the charge crystallised.<sup>176</sup>

The existence of the floating charge bears out the view expressed previously that 19th century lawyers could have developed a general lien. In some early cases in the 1870s in which the floating charge was given judicial blessing Jessel MR presided.<sup>177</sup> Yet, in *Re Hallett's Estate*,<sup>178</sup> whilst he endorsed the necessity for the tracing of money (albeit in a mixed form) before recovery could take place, he still retained the specific lien (referred to in the judgment as a charge) as a proprietary remedy. Therefore, he said in relation to tracing:

[T]he beneficial owner has a right to elect either to take the property purchased, or to hold it as a security for the amount of the trust money

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<sup>172</sup> *Holroyd v Marshall* (1862) 10 HL Cas 191; 11ER 999 *Reeve v Whitmore* (1863) 33 LJ Ch 63 and the later case of *Tailby v Official Receiver* (1888) 13 App Cas 523; Gough, above 166, 106-108.

<sup>173</sup> (1870) 5 Ch App 318. See also *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979; *Re General South American Co* (1876) 2 Ch D 337; *Re Florence Land and Public Works Co; ex parte Moor* (1878) 10 Ch D 530; *Re Colonial Trusts Corporation; Ex parte Bradshaw* (1880) 15 Ch D 465.

<sup>174</sup> *Re Yorkshire Woolcombers Association Ltd* [1903] 2 Ch 284; *Biggerstaff v Rowatt's Wharf Ltd* [1986] 2 Ch 93; Gough, above n 166, 90.

<sup>175</sup> *Re Panama; New Zealand and Australian Royal Mail Co* (1870) 5 Ch App 318; Gough, above n 167, 120.

<sup>176</sup> Gough, above n 166, 102; Chapters 8 and 11; *Stein v Saywell* (1969) 121 CLR 529, 556. (Kitto J).

<sup>177</sup> See *Re Florence Land and Public Works Co; Ex parte Moor* (1878) 10 Ch D 530, 543; *Re Colonial Trusts Corporation; ex parte Bradshaw* (1879) 15 Ch D 465, 472.

<sup>178</sup> (1880) 13 Ch D 696.



laid out in the purchase; or, as we generally express it, he is entitled at his election either to take the property, or to have a charge on the property for the amount of the trust property.<sup>179</sup>

Today, the specific lien remains an alternative proprietary remedy to a constructive trust.<sup>180</sup>

Ultimately, in relation to the floating charge, the need for mercantile flexibility won the day. Our legal system was forced to provide a legal mechanism which would cope with commercial needs. It is the contention of this thesis that we are facing a similar juncture in our history in relation to proprietary rights over money.<sup>181</sup> The general *hypotheca* model, reworked and refined to deal with our own commercial needs is the appropriate legal mechanism to redress unconscionable conduct.

#### IV TOWARDS THE DEVELOPMENT OF A GENERAL LIEN

The equitable lien, as a special hypothecation, is closely allied to equitable tracing which was discussed in Chapter 4. As will be recalled, before equitable tracing can be utilised, the specific res must be capable of being traced in its original, substituted or mixed form.<sup>182</sup> Still, the possibility that the equitable lien could operate in a even more flexible way was indicated in *Hewett v Court*. Gibbs CJ stated:

it is immaterial whether the moneys paid were in fact used by the company in the construction of the building. A purchaser's lien does not depend on the ability to trace the purchase moneys into the property over which the lien is created.<sup>183</sup>

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<sup>179</sup> Ibid, 709.

<sup>180</sup> *Swiss Bank Corporation v Lloyds Bank Ltd* (1979) 2 All ER 853, 867-869 (Browne-Wilkinson J); *Muschinski v Dodds* (1985) 160 CLR 583, 598 (Gibbs CJ); *Morris v Morris* [1982] 1 NSWLR 61.

<sup>181</sup> Chapter 1, 14-15.

<sup>182</sup> Chapter 2, 65-70.

<sup>183</sup> (1983) 149 CLR 639, 648.

It was sufficient to show that the vendor has been the recipient of the money.<sup>184</sup>

Besides loosening the nexus between the original asset and the lien, there have been signs that the general equitable lien may become utilised in our legal system. In *Space Investments Ltd v Canadian Imperial Bank of Commerce Trust Co (Bahamas) Ltd* ('Space'),<sup>185</sup> the facts of which are set out in Chapter 4,<sup>186</sup> Lord Templeman stated obiter:

It is therefore equitable that where the trustee bank has unlawfully misappropriated trust money by treating the trust money as though it belonged to the bank beneficially, merely acknowledging and recording the amount in a trust deposit account with the bank, then the claims of the beneficiaries should be paid in full out of the assets of the trustee bank in priority to the claims of the customers and other unsecured creditors of the bank.<sup>187</sup>

Lord Templeman justified this proposition on the basis that it followed *Re Hallett's Estate*.<sup>188</sup> In *Liggett v Kensington*,<sup>189</sup> the majority of the New Zealand Court of Appeal followed the obiter dicta in *Space* and held that the bullion company owed fiduciary obligations to the investors.<sup>190</sup> The company breached its fiduciary obligations because it failed to appropriate bullion to each of the accounts. Therefore, the investors (who should otherwise have been unsecured creditors) were entitled to take priority over the holder of a floating charge. However, on appeal, the Privy Council held that the company did not owe the investors fiduciary obligations and the investors were merely unsecured creditors.<sup>191</sup> Goff and Jones have suggested that a general lien may be an appropriate remedy for unjust enrichment and have identified the equitable lien as a response to mistaken payments,<sup>192</sup> breach of trust,<sup>193</sup>

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<sup>184</sup> In relation to the flexible application of the lien to assets see Graham Douthwaite, *Attorney's Guide to Restitution* (1977) [8.3].

<sup>185</sup> [1986] 1 WLR 1072.

<sup>186</sup> Chapter 4, 146.

<sup>187</sup> [1986] 1 WLR 1072, 1074. See also SJ Stoljar, *The Law of Quasi-Contract* (2<sup>nd</sup> ed, 1989), 143.

<sup>188</sup> *Ibid.*

<sup>189</sup> [1993] 1 NZLR 257 (Cooke P and Gault J, McKay J dissenting).

<sup>190</sup> *Ibid* 272-275 (Cooke P); 280-281 (Gault J).

<sup>191</sup> *Re Goldcorp Ltd (In Receivership)* [1995] 1 AC 74.

fraudulent misrepresentation<sup>194</sup> and undue influence<sup>195</sup> without the need for the application of tracing rules. Ultimately, it is the nature of the creditor's claim which is significant.<sup>196</sup>

What Lord Templeman was advocating and what the New Zealand Court of Appeal applied, was a general lien similar to the Roman tacit general *hypotheca* in its fullest form. There are considerable advantages in the development of a general equitable lien.

A general lien over the insolvent's property would enable a creditor to obtain a security interest in that property, without the need to point to the original funds or the funds in a substituted or mixed form. The general equitable lien would meaningfully address a central proposition which has recurred in this thesis - it is no longer feasible to require a specific proprietary base before providing proprietary remedies.

Also, it would end the straightjacket approach to the equitable lien which has so dominated our legal perceptions of it. Indeed, the author has never found a sufficiently cogent answer why the specific equitable lien applies in some cases and not in others. For example, why should the remedial relief available to vendors or purchasers of personal property be different from the remedial relief available to vendors or purchasers of real property? Why should purchasers such as the investors in *Liggett v Kensington*<sup>197</sup> acquire less rights in the fungible property they purport to purchase than a purchaser of land? And if they do, should proprietary relief be determined on factors other than whether the fungible property is specifically identifiable?

Finally, the evolution of a general lien would extricate the equitable lien from the trust (whether express or constructive). Moreover, as the equitable lien is not

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<sup>192</sup> Lord Goff of Chieveley and Gareth Jones, *The Law of Restitution* (3<sup>rd</sup> ed, 1986) 78-80.

<sup>193</sup> Goff and Jones, above n 13, 98-102.

<sup>194</sup> *Ibid.*

<sup>195</sup> *Ibid* 286.

<sup>196</sup> *Ibid* 101-102.

<sup>197</sup> [1993] 1 NZLR 257.

created by the intention of the parties, the concept of intention would not be contorted and manipulated out of all recognition. Rather, the courts have to consider what overall principle would govern the imposition of a general equitable lien in the light of the relationship of the parties.

### ***A Application of the General Equitable Lien***

Despite the theoretical attractions of the general equitable lien, it is necessary to consider its practical implications. As the general equitable lien is a theoretical construct at this stage, it has not been applied in an insolvency context before. There are a few cases such as *Space*<sup>198</sup> and *Liggett v Kensington*<sup>199</sup> which have presaged its operation.

Assuming that a creditor has established that he did not objectively assume the risk of a transaction, the question is - how should the general equitable lien operate? Courts exercising equitable jurisdiction have emphasised that equitable remedies are to be used with sensitivity and discretion.<sup>200</sup> So too, a general equitable lien would have to be applied sensitively consistent with the theory of objective non-assumption of risk.

Where the asset or assets which are in dispute are traceable in accordance with equity's tracing rules, then it would be appropriate for a creditor to seek to trace those identifiable assets. Where the creditor is able to trace the funds, the traditional lien operates in response to a breach of a fiduciary duty.

However, where equity's tracing rules were inapplicable because there was no breach of fiduciary obligations or the funds were wholly or in part untraceable, a party ought to be able to acquire a general equitable lien over assets of the insolvent to secure the original amount in dispute. Again, in this way, the lien would redress the unconscionable conduct of the insolvent and secure the creditor against the claims of all other unsecured creditors. Further, s 30 of the *Bankruptcy Act 1966* (Cth) enables the Court to make orders including declaratory orders, orders granting

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<sup>198</sup> [1986] 1 WLR 1072.

<sup>199</sup> [1993] 1 NZLR 257.

<sup>200</sup> *Coleman v Myers* [1977] 2 NZLR 225; *Cheese v Thomas* [1994] 1 WLR 129; *Waltons Stores (Interstate) Ltd v Maher* (1988) 164 CLR 387; *Commonwealth of Australia v Verwayen* (1990) 170 CLR 394.

injunctions or other equitable remedies. It is likely that a general equitable lien would fall within this provision.

## ***B How Would the General Equitable Lien Operate in an Insolvency***

### ***Context?***

The specific lien does not operate in the same way as the trust. This has an important consequence in insolvency contexts. The trust splits ownership and operates to remove the specific asset from the insolvent's asset base.<sup>201</sup> The lien does not operate to remove the asset or fund from the asset base of the insolvent. A specific lien operates as a security or charge over the assets of the insolvent. Section 5 of the *Bankruptcy Act 1966* (Cth) includes the lien in the definition of secured creditor. Such charges or liens may be created by the parties or they may operate by law (such as the liens which operate in response to breach of fiduciary duty)<sup>202</sup> or statute.<sup>203</sup> Indeed, a creditor may be secured even though there has not been complete compliance with registration requirements.<sup>204</sup> As the asset remains part of the underlying asset base of the insolvent, a creditor would have a number of practical courses open to it where a specific asset is involved.<sup>205</sup>

However, it would be entirely impractical for the general lienholder to prove the general lien in proceedings quite separate from the main bankruptcy proceedings. It would be inappropriate for a general lienholder to realise or surrender the general lien. Instead, the general lienholder would need to prove the amount due to him during the proceedings.

## ***C When Would the General Equitable Lien Commence Operation?***

Where a debtor is solvent, the operation of a general equitable lien will not be necessary. However, where the debtor is insolvent and the creditor can demonstrate

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<sup>201</sup> Note also *Bankruptcy Act 1966* (Cth) s 116 (2) (a).

<sup>202</sup> *Re Hallett's Estate; Knatchbull v Hallett* (1880) 13 Ch D 696.

<sup>203</sup> See for example *McQuade and Gronow*, above n 57, [5.1.115]. In relation to Torrens title mortgages see *Barry v Heider* (1914) 19 CLR 197; *Re Shoreline Homes Ltd* [1982] 1 NZLR 663.

<sup>204</sup> *Ibid.*

<sup>205</sup> *Bankruptcy Act 1966* (Cth) s 90

that he has not objectively assumed the risks of an unsecured creditor, then a general equitable lien ought to operate. Noyes has stated that the equitable lien

is that peculiar right to bring an action which is in form *in personam* and in effect *in rem*.<sup>206</sup>

It is submitted that a general equitable lien would arise over the assets of the insolvent on the occurrence of the later two events, namely,

(a) the unconscionable conduct of the insolvent (which forms part of the general theory of objective non-assumption of risk); and

(b) the insolvency itself - that point in time when the insolvency commences and a personal remedy would no longer satisfactorily redress the unconscionable conduct.<sup>207</sup>

It would not be appropriate for a general lien to operate at a time prior to the insolvency. The reason is that the operation of the general equitable lien would, technically speaking, preclude the insolvent from using and disposing of assets in a manner commensurate with ownership. However, upon insolvency, the general lien would operate, as Noyes has indicated, as a personal right in action with proprietary consequences.

### ***D How Would the General Equitable Lien Commence Operation?***

This issue has also arisen in relation to the imposition of the constructive trust and it is worth addressing various possible answers to the question.

First, it has been argued that how a constructive trust arises is dependent upon whether it is characterised as being an institutional constructive trust or a remedial constructive trust.<sup>208</sup> The former would arise without the need for a court

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<sup>206</sup> C Reinold Noyes, *The Institution of Property: A Study of the Development, Substance and Arrangement of the System of Property in Modern Anglo-American Law* (1936) 370.

<sup>207</sup> For a description of the circumstances when bankruptcy commences see *Bankruptcy Act 1966* (Cth) ss 5, 115 (1) and 115 (2) (a).

<sup>208</sup> For a consideration of and description of the institutional and remedial constructive trusts see Ford and Lee, above n 48, [22060]; Wright, above n 27, Chapter 2.

order. The latter would arise where there was an order of the court.<sup>209</sup> This bifurcation may create unnecessary disputation about the characterisation and consequences of the kind of constructive trust being in issue. Moreover, in *Muschinski v Dodds* ('*Muschinski*')<sup>210</sup> Deane J presaged the blurring of the line between these two kinds of constructive trust - at least in the way that they operate as remedies.<sup>211</sup>

Secondly, it has been suggested that whether or not the constructive trust operates in its institutional or remedial mode, it operates pursuant to an order of a court.<sup>212</sup> In this way, the constructive trust is differentiated from the express trust and the presumed resulting trust which are respectively based on actual and inferred intention.<sup>213</sup> In contrast, the constructive trust operates as a vehicle to give effect to a pre-existing obligation which the constructive trustee has breached.<sup>214</sup> Thus, the court not only recognises and enforces the trust, but also creates the trust. The merit of this approach is that it provides a uniform approach to the operation of the constructive trust. However, the attendant problem is that it appears that a court order is required for all forms of constructive trust - even where there has been a clear breach of traditional equitable obligation, such as breach of fiduciary duty.

A third approach has recognised that a constructive trust may arise and operate independently of a court order.<sup>215</sup> In such a case, a declaration of the aggrieved creditor's rights would simply recognise and enforce the constructive trust - it would not create the trust. This approach appears to have been endorsed in the

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<sup>209</sup> Barbara McDonald, 'Constructive Trusts' in Patrick Parkinson (ed) *The Principles of Equity*, (1996) 709, [2106]; Martin, above n 155, 291-292.

<sup>210</sup> (1985) 160 CLR 583.

<sup>211</sup> Ibid 614-615. For a discussion of this issue and some of the tensions which arise see Pamela O'Connor, 'Happy Partners or Strange Bedfellows: The Blending of Remedial and Institutional Features in the Evolving Constructive Trust' (1996) 20 *Melbourne University Law Review* 735; Ford and Lee, above n 48, [22060] and [22080].

<sup>212</sup> GE Dal Pont, 'Equity's Chameleon - Unmasking the Constructive Trust' (1997) 16 *Australian Bar Review* 46.

<sup>213</sup> Ibid 48-50.

<sup>214</sup> Ibid 51-65, 78.

<sup>215</sup> For a discussion of the kind of circumstances see Ford and Lee, above n 48, [22080]; Oakley, above n 155, 5-7.

United States.<sup>216</sup> In Australia and Canada, the position is more complex because the remedial constructive trust is rightly perceived as an inherently flexible remedy. In Australia, there is authority which indicates that a constructive trust may arise independently of a court order.<sup>217</sup> In *Muschinski*,<sup>218</sup> Deane J stated:

notwithstanding that the constructive trust is remedial in both origin and nature, there does not need to have been a curial declaration or order before equity will recognise the prior existence of a constructive trust...Where an equity court would retrospectively impose a constructive trust by way of equitable remedy, its availability as such a remedy provides the basis for, and governs the content of, its existence inter parties independently of any formal order declaring it or enforcing it.<sup>219</sup>

However, Deane J suggested that a constructive trust may be imposed and operate from the date of an order of the court where competing common law or equivalent claims are in issue.<sup>220</sup> In making these comments, he highlighted that where remedial concerns were in issue, the dichotomy between the institutional constructive trust or the remedial constructive trust begins to disappear.<sup>221</sup> Moreover, where claimants have rights to equitable relief due to unconscionable conduct, such rights do not automatically translate into a proprietary remedy. Indeed in *Muschinski*, Deane J pointed out that:

in this country at least, the constructive trust has not outgrown its formative stages as an equitable remedy and should still be seen as an in personam remedy attaching to property which may be moulded and

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<sup>216</sup> Scott and Fratcher, above n 32, vol V §462.4. For a consideration of this approach see Wright, above n 27, [8.1]-[8.10].

<sup>217</sup> See for example *Queenland Mines Ltd v Hudson* [1975-1976] ACLC 40-266, 28,708-709 (reversed on appeal on other matters (1978) 18 ALR 1); *Re Osborn*; *Ex parte Trustee of Property of Osborn v Osborn* (1989) 25 FCR 517; (1989) 91 ALR 135; *Re Jonton Pty Ltd* [1992] 2 Qd R 105; *Zobory v Federal Commissioner of Taxation* (1995) 64 FCR 86; *Greater Pacific Investments Pty Ltd (in liq) v Australian National Industries Ltd* (1996) 39 NSWLR 143; *Re Sabri*; *Ex parte Brien v Sabri and the ANZ Banking Group* [1996-1997] 21 Fam LR 213. For a discussion of the position see Meagher and Gummow, above n 48, [1311].

<sup>218</sup> (1985) 160 CLR 583.

<sup>219</sup> *Ibid* 614.

<sup>220</sup> *Ibid* 615.

<sup>221</sup> *Ibid* 614-616.



adjusted to give effect to the application and interplay of equitable principle in the circumstances of the particular case.<sup>222</sup>

Instead, the court may provide personal relief or no relief at all, where it considers that the claimant would obtain a double benefit.<sup>223</sup> In Canada also, the Supreme Court has indicated that proprietary relief is not an automatic consequence of unjust enrichment.<sup>224</sup> Courts ought to consider whether there are other appropriate remedies which will not interfere with the rights of third parties.<sup>225</sup>

Turning to the possible operation of the general equitable lien, it is strongly arguable that whilst the rights for relief in the form of an equitable lien, exist prior to a court order, it will be necessary for a creditor to obtain a court order declaring an equitable lien. There are several reasons for this. A claim for proprietary relief does not preclude the vesting of property in insolvency administration.<sup>226</sup> Instead, property vests in the administrator subject to such claims for equitable relief.<sup>227</sup> It is not a function of an insolvency administrator to determine whether a creditor is entitled to proprietary relief. Indeed, to do so would leave the administrator open to criticism that he had not acted appropriately.<sup>228</sup> Under s 178 of the *Bankruptcy Act 1966* (Cth) a creditor who is affected by an act, omission or decision of a trustee, may apply to the court for an order dealing with these matters.<sup>229</sup> And, the administrator may be personally liable<sup>230</sup> if he is found guilty of breach of duty.<sup>231</sup>

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<sup>222</sup> Ibid 615.

<sup>223</sup> *Australian National Industries Ltd v Greater Pacific Investments Pty Ltd (in liq)* (1992) 7 ACSR 176.

<sup>224</sup> *Sorachan v Sorachan* [1986] 2 SCR 38, 47; (1986) 29 DLR (4th) 1, 7-8 (Dickson CP); *Rawluk v Rawluk* [1990] 1 SCR 70; (1990) 65 DLR (4th) 161.

<sup>225</sup> See *Rawluk v Rawluk* [1990] 1 SCR 70, 103-104; (1990) 65 DLR (4th) 161, 185-186 (McLachlin J).

<sup>226</sup> See for example, *Bankruptcy Act 1966* (Cth) s 59.

<sup>227</sup> See for example, *Re Clark; Ex parte Beardmore* [1894] 2 QB 393; *Corke v Corke* (1994) 121 ALR 320, 326-327 (Lockhart J).

<sup>228</sup> McQuade and Gronow, above n 57, [154A.0.10].

<sup>229</sup> Ibid [178.0.10].

<sup>230</sup> *Bankruptcy Act 1966* (Cth) s 176.

<sup>231</sup> For a definition of 'breach of duty' see *Bankruptcy Act 1966* (Cth) s 5.

Moreover, the rights and interests of third parties, as identified by Deane J in *Muschinski*,<sup>232</sup> remain important considerations as well. The problems associated with a general equitable lien and third parties will be discussed further. Finally, in the light of the fact that the importance of a general equitable lien would be a new development in the law, a court order imposing one would be necessary.

### ***E What Value Would be Secured by the General Equitable Lien?***

A general equitable lien over assets would secure an amount equivalent to the sums transferred to the insolvent or collected by the insolvent as an agent.

However, in the light of the decision in *Westdeutsche*,<sup>233</sup> the issue of interest payable on a disputed amount may need to be addressed. In this case, the disputed amount was repaid to the bank. The council had effective use of the money for a substantial period of time and had derived income from it. At the same time, the bank lost revenue. Therefore, the bank claimed compound interest on the basis that the bank had retained an equitable interest in the money under a resulting trust. A majority of the House of Lords held that the bank was only entitled to simple interest under the common law.<sup>234</sup> Lord Goff and Lord Woolf, in dissenting judgments, held that the jurisdiction to award compound interest was not limited to traditional proprietary claims. Equity was capable of awarding compound interest when justice demanded it.<sup>235</sup>

The problem is, how should courts deal with interest claims in insolvency situations.<sup>236</sup> The House of Lords in *Westdeutsche* was not presented with this difficulty. It is submitted that there are four possible approaches to such a claim.

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<sup>232</sup> (1985) 160 CLR 583, 615.

<sup>233</sup> [1996] AC 669. See also *Ausintel Investments Australia Pty Ltd v Lam* (1990) 19 NSWLR 637.

<sup>234</sup> *Ibid*, 700-702 (Lord Browne-Wilkinson); 718-719 (Lord Slynn of Hadley) and 737-741 (Lord Lloyd of Berwick).

<sup>235</sup> 684, 690-698, (Lord Goff of Chieveley); 724-730, 735-737 (Lord Woolf). Note also Mason and Carter, above n 12, [2813]-[2817]; Martin, above n 155, 638-639.

<sup>236</sup> For a discussion of the present law in relation to interest see Mason and Carter, above n 12, Chapter 28.

First, it could be argued that the creditor is not entitled to any interest whatsoever. The problem here is that this approach does not take into account the fact that if the insolvent has retained the funds for some time (even if the funds are no longer in existence or traceable) the insolvent is likely to have earned considerable income or offset losses with it. Equally, the creditor may have suffered a loss as well.

Secondly, as the general lien arises in response to personal action, it could be contended that simple interest is sufficient. The award of interest would acknowledge that the creditor has suffered a hypothetical loss and the insolvent made a gain. Yet, despite its attractive simplicity, this method does not deal with the fact that the insolvent may have used the money in such an entrepreneurial fashion so as to obtain an income well in excess of simple interest.

Thirdly, as an equitable lien is a form of equitable proprietary remedy, compound interest ought to be available. Traditionally, compound interest is awarded where there is evidence of unconscionable conduct, such as a breach of fiduciary obligations. Therefore, as the theory of objective non-assumption of risk incorporates an evaluation of unconscionable conduct, compound interest is an appropriate response. Again, this method does not take into account how the insolvent has used the money to gain additional income.

A fourth (and in the author's view, a preferable) approach, is to place the issue of interest in a broader framework. The essential question is to what extent (if at all) did the insolvent earn income on the disputed amount and whether there was an augmentation of the insolvent's assets via income received or expenditure saved? Therefore, an evaluation of whether an amount, in addition to the original amount, is payable emphasises the insolvent's actual or likely gains rather than simply the creditor's hypothetical losses. This approach does accord with the way that equity deals with unconscionable conduct, such as breach of fiduciary obligations. Where a trustee or fiduciary breaches his fiduciary obligations, he is required to repatriate not only the assets of the trust to the trust, but also any income or profits derived from the assets as well.<sup>237</sup> Therefore, the actual accretions to the insolvent and hypothetical losses to the creditor could be dealt with as follows:

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<sup>237</sup> *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378; [1967] 2 AC 134n; *Boardman v Phipps* [1967] 2 AC 46; *Warman International Ltd v Dwyer* (1995) 182 CLR 544.

(i) where it is possible to ascertain precisely the income derived by the insolvent (whether or not equitable tracing rules apply), the creditor should be entitled to the income earned; or

(ii) where it is impossible to ascertain the precise income but it is possible to ascertain the likely accretions (or there has been an effectual accretion in the light of how the insolvent treated the original funds), the creditor should be entitled to those accretions; or

(iii) where it is impossible to ascertain actual or likely accretions or the insolvent has made a loss in relation to the use or investment of the funds, the creditor should be entitled to compound interest at a rate generally prescribed by the court in equity cases for such a period.<sup>238</sup>

Such a scheme emphasises that creditors are primarily entitled to gains made by the insolvent. In this way, the insolvent's assets are not unnecessarily diminished by claims based on ludicrous hypothetical losses. Therefore, the legitimate interests of other unsecured creditors are respected. On the other hand, the insolvent is not entitled to retain gains made pursuant to unconscionable conduct. However, where it is not possible to determine the actual or likely income or gains made by the insolvent, the creditor is still entitled to claim a hypothetical loss. The rationale for such a claim is that a creditor should be placed in the position he would have been if the unconscionable conduct had not taken place.<sup>239</sup> One foreseeable argument against the suggested scheme is that market interest may exceed the actual income or likely gains made by the insolvent. Therefore, the creditor should be entitled to the higher of the two amounts. However, such an argument re-shifts the analysis towards seeking the best possible result from actual income or likely gains on the one hand or hypothetical losses on the other. Rather, the major operative principle should be the disgorgement of gain. The calculation of interest for hypothetical losses is a fall-back position. Where the fall-back position is utilised, the interest ought to be calculated from the date of receipt by the insolvent rather than the date of insolvency or date of

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<sup>238</sup> See Mason and Carter, above n 12, [2814].

<sup>239</sup> For cases which applied this approach in relation to equitable compensation see *Re Dawson* [1966] 2 NSW 211; *Hill v Rose* [1990] VR 129.

the court order in order to reflect the extent of the benefit acquired.<sup>240</sup> The suggested scheme is consistent with the swollen assets theory considered in Chapter 4.

A few examples will illustrate the application of the scheme.

If an insolvent deposits funds in an account and the account accrues interest, then a creditor should be entitled to the fund and interest earned. The situation falls within item (i) above.

If an insolvent (whether or not the insolvent owes fiduciary obligations) uses the funds to pay off a commercial overdraft, then the insolvent is not holding an actual gain. However, there has been a positive accretion to the estate because the insolvent has effectively saved paying interest on the overdraft. In such a case, the creditor should be entitled to an amount equivalent to the interest saved - taking into account a reasonable estimation of how long it would have taken the insolvent to otherwise pay the overdraft. This situation falls within item (ii) above.

If an insolvent's records and accounts were lost or incomprehensible, this ought not be a bar to the creditor securing payment of compound interest under item (iii).

### ***F Over What Property Belonging to the Insolvent Would a General Equitable Lien Operate?***

As the assets remain in the hands of the insolvent, questions about priorities will arise; or, to put it another way, the issue will be over what assets of the insolvent will the lienee obtain security? There are four possible kinds of property over which a general equitable lien could operate.

#### ***1 Unencumbered Assets***

Lord Templeman in *Space*<sup>241</sup> and Goff and Jones<sup>242</sup> have suggested that a general lien could only operate over unencumbered assets. This proposition is a

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<sup>240</sup> Mason and Carter, above n 12, [2808].

<sup>241</sup> [1986] 1 WLR 1072, 1074.

<sup>242</sup> Goff and Jones, above n 192, 80; Goff and Jones, above n 13, 98-99; 286; Gareth Jones, 'Tracing Claims in the Modern World' [1988-1989] *King's Counsel* 15, 19.

helpful one because it shows that where there are unencumbered assets, these assets should be utilised first to pay out a creditor secured under the general lien. Therefore, even though a creditor is unable to access equity's traditional tracing rules (for any variety of reasons), such a party should be treated in priority to other unsecured creditors via a general equitable lien over unencumbered assets.

The problem with this suggestion is that the bulk of the assets of the insolvent may secure the indebtedness of the insolvent. Therefore, the value of the assets which may be unencumbered is minimal. Moreover, such assets, where an individual is involved, may be personal effects such as clothes and household property which are exempted from the property available for distribution.<sup>243</sup>

One situation which may arise is where the whole or part of the assets are encumbered and the secured assets have been realised and the secured creditor has been paid out. There may be funds available from the realisation of the security for payment to the unsecured creditors. Here, the general lienholder ought to have a security interest. In such a case, both the secured creditor and the general lien holder would have priority over the unsecured creditors. The secured creditor took measures to alleviate risk. The general lienholder did not objectively assume the risks associated with being an unsecured creditor.

## ***2 Assets Subject to a Floating Charge***

It is arguable that there should be no bar to a general lienholder's claim where there are no unencumbered assets because the assets of an insolvent company are subject to a floating charge. In *Liggett v Kensington*,<sup>244</sup> the facts of which are considered in Chapter 6,<sup>245</sup> a dispute arose between a debenture holder which appointed receivers of Goldcorp Exchange Ltd and the unsecured creditors. A majority of the New Zealand Court of Appeal held that the customers were entitled to priority over the debenture holder in the form of a constructive trust on the basis

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<sup>243</sup> *Bankruptcy Act 1966* (Cth) s 116(2)(b).

<sup>244</sup> [1993] 1 NZLR 257.

<sup>245</sup> Chapter 6, 228.

that the unsecured creditors had not taken on the risk of insolvency whilst the debenture holder had.<sup>246</sup>

The debenture holder was aware that despite the fact that the floating charge is a flexible mechanism, it does have one major drawback. A floating charge must crystallise before it attaches to specific property and the chargor's right to dispose of the property, which is subject to the charge, comes to an end.<sup>247</sup> Therefore Cooke P was able to rationalise the imposition and priority of the constructive trust, not only on the unconscionable conduct of the insolvent (in this case characterised as a breach of fiduciary obligations), but also on the inherent limitation of the floating charge in relation to the trust. Therefore, a party who had not objectively assumed risk, could acquire priority over not only other unsecured creditors, but also secured creditors who had not sought a sufficiently adequate or effective security.

However, on appeal in *Re Goldcorp Exchange Ltd (In Receivership)*<sup>248</sup> the Privy Council rejected the views of the majority of the Court of Appeal. Lord Mustill (who delivered the judgement for the Privy Council) stated:

There remains the question whether the court should create after the event a remedial restitutionary right superior to the security created by the charge. The nature and foundation of this remedy were not clearly explained in argument. This is understandable, given that the doctrine is still in an early stage and no single juristic account of it has yet been generally agreed. In the context of the present case there appear to be only two possibilities. The first is to strike directly at the heart of the problem and to conclude that there was such an imbalance between the positions of the parties that if orthodox methods fail a new equity should intervene to put the matter right, without recourse to further rationalisation. Their Lordships must firmly reject any such approach. The bank relied on the floating charge to protect its assets; the customers relied on the company to deliver the bullion and to put in place the separate stock. The fact that the claimants are private citizens whereas their opponent is a commercial bank could not justify the court in simply disapplying the bank's valid security. No

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<sup>246</sup> *Liggett v Kensington* [1993] 1 NZLR 257, 274-275 (Cooke P); 280-283 (Gault J). McKay J dissented.

<sup>247</sup> Gough, above n 166, 135. For a discussion of what crystallisation entails see Chapters 8 and 11 of the same work.

<sup>248</sup> [1995] 1 AC 74.

case cited has gone anywhere near to this, and the Board would do no service to the nascent doctrine by stretching it past breaking point.<sup>249</sup>

The Privy Council's approach was an affirmation of securities as mechanisms for the minimisation of risk. In comparison, *Cooke P* treated the floating charge as a second class security in comparison to other forms of fixed security - even though the floating charge may have been the only practical security available. Thus, the Privy Council considered that the efficacious realisation of a pre-existing security took precedence over redressing unconscionable conduct (in the fuller context of the objective non-assumption of risk). This is a significant issue which awaits further judicial analysis. But the comments made below in relation to fixed securities also apply to floating charges.

### ***3 Assets Subject to Fixed Securities***

At this stage, it is unclear what course courts would take where all or a substantial part of the assets of the insolvent are subject to fixed securities. There are two courses open to them. Courts may choose to assert the traditional priority status of secured creditors over any kind of unsecured creditor. The rationale for this approach is that secured creditors have not assumed the risk of the insolvency of the debtor because they have taken measures to minimise risk. The strength of such an argument is augmented by s 90 of the *Bankruptcy Act 1966* (Cth) which entitles secured creditors to realise securities outside the statutory scheme.

Alternatively, the courts could assert that there is a difference between secured creditors who have taken measures to protect themselves and parties who have not assumed the risk because they have not had an opportunity to minimise risk. In the light of the theory of objective non-assumption of risk, such a party should take priority even over secured creditors.

It appears that such cases as *Neste Oy v Lloyd's Bank plc*<sup>250</sup> and *Theiss Watkins White Ltd v Equiticorp Australia Ltd*<sup>251</sup> there was no need to consider this issue because there were adequate liquidated and unencumbered funds. Nevertheless,

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<sup>249</sup> Ibid 104.

<sup>250</sup> [1983] 2 Lloyd's Rep 658.

<sup>251</sup> [1991] 1 Qd R 82.



there are strong arguments against the priority of a general equitable lien over fixed securities.

Parties often enter into commercial transactions on the basis that the transaction is secured. Therefore, the availability of a legal system under which securities are recognised and given full operation, is essential for commercial activity. Once the effective operation of a fixed security is impaired by the prioritised operation of the general equitable lien, then commercial uncertainty follows. Moreover, the substantial statutory development of securities of all kinds would be undermined by the intervention of equity and the special status of secured transactions under an insolvency regime.<sup>252</sup>

Valid securities have the effect of withdrawing the secured property from the asset base available for distribution. For example, s 90 of the *Bankruptcy Act 1966* (Cth) permits a secured creditor to simply rely entirely on the security without the need to lodge proof of the debt at all or realise the security independently of the bankruptcy proceedings and prove for any balance still owing. If a general equitable lien were permitted to operate, this would have the effect of undermining the central function of securities.

Further, secured parties may have no notice of the insolvent's unconscionable conduct. Actual and constructive notice are important criteria in undue influence cases,<sup>253</sup> unconscionable dealing<sup>254</sup> and the rule under *Barnes v Addy*.<sup>255</sup> Before there can be equitable intervention, the third party must have actual or constructive notice of the unconscionable conduct. The concept of notice is directly linked to the principle that equity does not operate or intervene against a bona fide purchaser for

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<sup>252</sup> *Re Osborn; Ex parte Trustee of Property of Osborn v Osborn* (1989) 25 FCR 547, 553-554; 91 ALR 135, 142; *Re Goldcorp Exchange Ltd (In Receivership)* [1995] 1 AC 74, 103-105 (Lord Mustill).

<sup>253</sup> *Bank of New South Wales v Rogers* (1941) 65 CLR 42; *Barclays Bank plc v O'Brien* [1994] 1 AC 180.

<sup>254</sup> *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447; Tony Duggan, 'Unconscientious Dealing' in Patrick Parkinson (ed), *The Principles of Equity* (1996) 121, [513].

<sup>255</sup> (1874) LR 9 Ch App 244; McDonald, above n 209, [2130]-[2132]; [2136]-[2137]; cf *Royal Brunei Airlines Sdn Bhd v Tan* [1995] AC 378 and Meagher and Gummow, above n 48, [1335]-[1337].

value without notice who acquires the legal estate.<sup>256</sup> It would be incongruous and contrary to the traditional operation of equity if the interests of a bona fide purchaser for value, such as a secured lender, were subordinated to the interests of a general lienee.

The arguments in favour of a general equitable lienee are also cogent in the light of the serious nature of unconscionable conduct. The argument that the intervention of equity would create commercial uncertainty should be seen in perspective. Equity would intervene on a principled basis in only the most exceptional circumstances where a creditor could not be expected to assume risk and the insolvent has acted unconscionably in the augmentation of his asset base.

Indeed, a central function of equity is the prevention of and redress for legal and equitable wrongdoing. Even in the 19th century, equity retained jurisdiction (albeit a limited one) to redress unconscionable conduct.<sup>257</sup> If courts were to limit equitable relief to cases where there were adequate unencumbered assets available, then the courts would be artificially limiting remedial relief for unconscionable conduct. Therefore, instead of the proprietary base requirement becoming an obstacle to proprietary relief, the existence or non-existence of fixed securities would create a barrier. One of the features of the constructive trust imposed in *Liggett v Kensington* was that it operated to furnish the customers with priority over all other secured parties. This was achieved by the trust mechanism withdrawing the assets from distribution amongst other secured and unsecured creditors until the claims of the customers had been satisfied. It could be argued that, for this reason, the constructive trust is a preferable mechanism. However, the same can effect may be achieved by a general equitable lien if it were acknowledged that such a lien would take precedence over other securities, where the value of the unencumbered assets was less than the amount claimed by a creditor.

Notwithstanding the existence of statutory schemes in relation to land and the administration of insolvency, equity has remained an important contributor to the operation of these schemes.<sup>258</sup> In *Ex parte James; Re Condon*,<sup>259</sup> it was held that

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<sup>256</sup> Patrick Parkinson and David Wright, 'Equity and Property' in Patrick Parkinson (ed), *The Principles of Equity* (1996) 53, [315].

<sup>257</sup> Chapter 1, 27-29.

<sup>258</sup> *Ibid* 29, 34-36.

<sup>259</sup> (1874) LR 9 Ch App 609; Chapter 1, 34-35.

equitable principles still applied in the course of a bankruptcy. Concomitant with the concern that there should be fair dealing in the administration of insolvent estates, there has been the broad interpretation of the concept of trust under s 116 (2) (a) of the *Bankruptcy Act 1966* (Cth). One author has pointed out that the concept of trust under the legislation has gone well beyond situations where specific and traditional trusts operate to include relationships which may be considered fiduciary.<sup>260</sup> In this way courts have tried to address unconscionable conduct on a piecemeal basis. The recognition of a general lien over all of the assets of an insolvent would clearly provide an effective form of proprietary relief in response to unconscionable conduct.

Finally, the operation of a general equitable lien would not undermine the function of specific securities such as the mortgage or the charge. Rather, the existence of the general equitable lien would simply mean that priority issues would have to be resolved between two different kinds of secured creditors, namely the creditors under the fixed securities and the creditor under the general equitable lien. The definition of secured creditor under s 5 of the *Bankruptcy Act* includes the operation of equitable securities such as the equitable mortgage, the equitable lien or the equitable charge.

#### ***4 Statutory Exceptions to the Rateable Distribution Policy***

As previously discussed,<sup>261</sup> in bankruptcy and insolvency legislation certain unsecured creditors are accorded priority over all other creditors. For example, s 109 *Bankruptcy Act 1966* (Cth) sets out certain specific claims and relationships which are accorded special priority, such as petitioner's costs,<sup>262</sup> trustee's remuneration and expenses,<sup>263</sup> funeral and testamentary expenses,<sup>264</sup> wages and salaries of the employees of the insolvent to a limited extent,<sup>265</sup> workers compensation claims<sup>266</sup>

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<sup>260</sup> Dennis Rose, above n 57, 139.

<sup>261</sup> Chapter 1, 33. See generally McQuade and Gronow, above n 57, [109.0]-[109.10.05].

<sup>262</sup> *Bankruptcy Act 1966* (Cth) s 109 (1) (a)

<sup>263</sup> *Bankruptcy Act 1966* (Cth) s 109 (1) (b)

<sup>264</sup> *Bankruptcy Act 1966* (Cth) s 109 (1) (d)

<sup>265</sup> *Bankruptcy Act 1966* (Cth) s 109 (1) (e)

<sup>266</sup> *Bankruptcy Act 1966* (Cth) s 109 (1) (f)

and child support.<sup>267</sup> These items are subject to internal priority. The question is how is the apparent conflict between the interests of the general lienee on the one hand and the parties accorded special priority in the legislation on the other reconciled?

The special prioritised exceptions to the rateable distribution principle may be explained on two bases. Some of the exceptions such as petitioner's costs and trustee's expenses relate to the costs incurred in relation to the administration of the insolvency. It is not appropriate that the petitioner or the trustee in bankruptcy should bear the costs of the insolvency. Otherwise, there would be no incentive for creditors to bring petitions or trained parties to act as trustees in bankruptcy.

Another rationale for the prioritised legislative list is that it provides for protection of parties who are unable to otherwise take action to obtain security in the event of insolvency. Thus, it is arguable that the legislation contains a version of the objective non-assumption of risk theory in relation to a level of wages and salaries. Employees do not assume the risk of the employer's insolvency. Instead, what occurs is that the employee swells the assets of the employer by the use of his labour. If the employee is not accorded even a partial preferential status in relation to the assets of the insolvent, it will mean that the employee has swelled the assets of the employer to the benefit of other unsecured creditors, some of whom may have been able to take action to avoid the risk of insolvency. The employee cannot demand security for the value of the labour and it would be unconscionable for the insolvent employer to retain the goods or the benefits of the services without payment of some salaries and associated costs. Indeed, s 561 of the *Corporations Law* (Cth) recognises the priority of employee's claims over floating charges. Therefore, for practical and policy reasons, the small (but highly significant) legislative exceptions to rateable distribution should be followed. Thus, these specific exceptions should have first priority before any general lien as a response to unconscionable conduct.<sup>268</sup>

Therefore, a general equitable lien would be an appropriate proprietary response to most claims based on objective non-assumption of risk. Certainly, it would be a fitting proprietary response where funds are untraceable and the insolvent has unencumbered assets which are equivalent to or more than the amount in dispute.

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<sup>267</sup> *Bankruptcy Act 1966* (Cth) s 109 (1A) (a)

<sup>268</sup> For an adherence to this approach see *Lennox Industries (Canada) Ltd v The Queen* (1987) 34 DLR (4th) 297, 307-310 (Reed J) and *Re Permanent House (Holdings) Ltd* [1988] BCLC 563; cf *Griffiths v Yorkshire Bank plc* [1994] 1 WLR 1427.

Whether the general equitable lien should extend to assets subject to floating and fixed securities is still open to debate.

## V DEFENCES

Even if a creditor as plaintiff establishes that, objectively speaking, he could not be expected to take on the risk of the transaction, he may not be successful. It is likely that an insolvent debtor may be able to raise successfully a defence against the plaintiff. The kinds of defences which may be raised in an action for proprietary relief remain largely undetermined. However, it is suggested that there are two major kinds. First, there are defences which are based on a critical evaluation of the actions or inactions of the plaintiff. Secondly, there are those defences in which the conduct of the insolvent is central.

### *A Defences Based on the Conduct of the Creditor as Plaintiff*

#### **1 Introduction**

The insolvent's administrators may be able to raise many of the standard defences traditionally made against a plaintiff seeking equitable relief. The effect of such defences may be that the creditor may secure neither personal nor proprietary relief. Another way of stating this is that if the defence is available in cases of solvency, it will also operate in cases of insolvency.

#### **2 Illegality**

The insolvent's administrators may be able to argue that the plaintiff has entered into an illegal transaction and should not be entitled to any equitable relief whatsoever.

In relation to contracts which are illegal for public policy reasons<sup>269</sup> or are contracts prohibited by statute,<sup>270</sup> the traditional position has been that:

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<sup>269</sup> For a helpful discussion see Greig and Davis, above n 1, 1126-1145.

<sup>270</sup> Goff and Jones, above n 13, Chapters 19 and 22; Greig and Davis, above n 1, 1116-1117.

No Court will lend its aid to a man who founds his cause of action upon an immoral or an illegal act.<sup>271</sup>

Illegality has been an effective defence. But, the underlying philosophy of this approach has been challenged by the High Court of Australia decision in *Nelson v Nelson*,<sup>272</sup> a case on illegal trusts.

There are two different types of illegal contracts. In the first kind, the plaintiff is unaware of the fact that the contract is illegal, namely, the parties are not *pari in delicto*. He may have a range of additional factors available on the basis of ignorance, including mistake of some relevant fact,<sup>273</sup> fraud,<sup>274</sup> pressure or oppression.<sup>275</sup> Where the contract is executory<sup>276</sup> and the plaintiff discovers that the contract is illegal, he may withdraw from the contract prior to its fulfilment and recover the money which has been paid under the contract.<sup>277</sup> If the contract has been performed or partly performed, the plaintiff will have no access to personal or proprietary relief.<sup>278</sup>

The second kind of case is where the plaintiff enters into the contract knowing that the contract is illegal. Where the contract is executory he may

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<sup>271</sup> *Holman v Johnson* (1775) 1 Cowp 341, 343; 98 ER 1120, 1121 (Lord Mansfield). This rule has been applied in a large number of modern cases, including *Parkinson v College of Ambulance Ltd and Harrison* [1925] 2 KB 1; *Re National Benefit Assurance Co Ltd* [1931] 1 Ch 46; *Berg v Sadler and Moore* [1937] 2 KB 158; *JM Allan (Merchandising) Ltd v Cloke and Another* [1963] 2 QB 340; *Shaw v Shaw* [1965] 1 WLR 537; *Ashmore, Benson, Pease & Co Ltd v A W Dawson* [1973] 1 WLR 828; *Spector v Ageda* [1973] Ch 30; *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168.

<sup>272</sup> (1995) 184 CLR 538.

<sup>273</sup> *Oom v Bruce* (1810) 12 East 225; 104 ER 87; *Clay v Yates* (1856) 1 H & N 73; 156 ER 1123.

<sup>274</sup> *Hughes v Liverpool Victoria Friendly Society* [1916] 2 KB 482.

<sup>275</sup> *Smith v Bromley* (1760) 2 Doug 696n; 99 ER 441; *Smith v Cuff* (1817) 6 M & S 160; 105 ER 1203; *Atkinson v Denby* (1861) 6 H & N, 158 ER 321; affd 7 H 7 N 934; 158 ER 749; *Williams v Bayley* (1866) LR 1 HL 200.

<sup>276</sup> For a discussion of the origins of the executory contract see Atiyah, above n 124, 419-434.

<sup>277</sup> *Taylor v Bowers* (1876) 1 QBD 291; *South Western Mineral Water Co Ltd v Ashmore* [1967] 1 WLR 1110.

<sup>278</sup> *Lowry v Bourdieu* (1780) 2 Doug 468; 99 ER 299. See Goff and Jones, above n 13, 488-490 and the authorities cited therein.

withdraw from the contract until it is performed by the other side on the basis that such a withdrawal indicates repentance or *locus poenitentiae*.<sup>279</sup> Where the illegal contract has been partly performed, the traditional approach has been to let the loss lie where it falls.<sup>280</sup> In this case the plaintiff co-wrongdoer will be unable to recover his money. This approach is taken because he did enter into the transaction aware of accepting its illegal nature and the risks associated with such illegality. Still, the objection to the general rule applicable to both kinds of situations which have been highlighted is that:

To nullify bargains because of illegality when the law is unwittingly broken may require a contracting party to forfeit a sum 'vastly in excess of any penalty that a criminal court would impose; and the sum forfeited will not go into the public purse but into the pockets of someone who is lucky enough to pick up the windfall or astute enough to have contrived to get it.'<sup>281</sup>

An alternative approach to the defence of illegality is analogous to the examination which the High Court undertook. In *Nelson v Nelson*,<sup>282</sup> the Court looked further afield and investigated how courts in the United States dealt with illegality.<sup>283</sup> Two parties had knowingly participated in setting up a trust for an illegal purpose. A mother used her own funds to purchase a property in the name of her son and daughter. Subsequently, she obtained substantial funds under the *Defence Service Homes Act 1918* (Cth). In order to access this finance, she was required to declare that she had no other interest in a property. Later, the mother and the children disagreed as to who owned the first property. The son conceded his mother's interest but the daughter refused to do so. The mother was clearly in breach of the legislation. The daughter retained the property which prima facie, under the law relating to resulting trusts, belonged to the mother.<sup>284</sup> The Court balanced the interests of the two wrongdoers and did not permit the daughter to retain the

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<sup>279</sup> *Bigos v Boustead* [1951] 1 All ER 92.

<sup>280</sup> *Holman v Johnson* (1775) 1 Cowp 341; 98 ER 1120.

<sup>281</sup> Goff and Jones, above n 13, 519. See also Andrews Burrows, *The Law of Restitution* (1993) 334-341.

<sup>282</sup> (1995) 184 CLR 538.

<sup>283</sup> *Ibid*, 566-567 (Deane and Gummow JJ).

<sup>284</sup> Chapter 2, 56-60.

proprietary benefit. However, the mother was required to repay funds which she had received under the legislative scheme.<sup>285</sup> The extent to which personal remedies should be available needs to be worked out in the light of the policy considerations raised by such cases as *Nelson v Nelson*. Until then, a discussion of the availability of proprietary remedies cannot be made with confidence.

Nonetheless, a few points can be made in relation to proprietary relief. Where the plaintiff shows that he or she was induced by fraud, pressure or undue influence to enter into the illegal transaction then that person should be entitled to a proprietary remedy where the other wrongdoer is insolvent. This is consistent with equitable intervention where the unconscionable conduct occurs prior to the transaction.<sup>286</sup>

Where the plaintiff shows that it was a case of a genuine mistake on his part, or both parties were genuinely ignorant then, *prima facie*, he should be able to obtain proprietary relief subject to the other requirements of the theory of objective non-assumption of risk.

However, where the plaintiff knew of the illegality and the contract is executory, it is more difficult. Although it is arguable that the plaintiff assumed the risk and illegality of the transaction, the plaintiff should be able to recover in principle, as the illegal purpose has not been fulfilled. The basis of this suggestion is that it would be unjust to permit an insolvent or his unsecured creditors to obtain some financial relief from what are ill-gotten gains. It is also arguable that the insolvent had committed potentially two acts of unconscionable conduct - namely, the insolvent entered into a contract which he knew was illegal; and, upon discovery of the illegality of the contract, the insolvent refused to disgorge the benefit obtained under it.

Finally, when the contract has been partly or fully fulfilled, then the question is whether equity may intervene on the basis of unconscionable retention of property. Again, it is arguable that the plaintiff has assumed the risk and illegality of the transaction. Therefore, proprietary relief should not be available. However, the problem is that the insolvent has acted wrongfully in two instances and his creditors would obtain a windfall. In this situation, proprietary relief should be seriously

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<sup>285</sup> *Nelson v Nelson* (1995) 184 CLR 538, 571-572 (Deane and Gummow JJ); 616-618 (McHugh J); cf 597-598 (Toohey J).

<sup>286</sup> Chapter 6, 227.



considered. It may depend upon whether the parties may be restored, in a practical sense, to the pre-illegality situation. It will be recalled that in *Nelson*<sup>287</sup> a majority of the High Court held that before the plaintiff was able to access relief, she was required to disgorge the funds which she had obtained pursuant to the illegal purpose. In so doing, she restored herself to the pre-illegality situation. Thereafter, she was entitled to re-acquire the house which she had transferred to her daughter. In this case it was easy to re-adjust to a pre-illegality situation. What can be said is that if a plaintiff wishes to assert either a personal or proprietary remedy, then he cannot expect to retain property which has been acquired through illegality.

### 3 Clean Hands

It may be argued that the plaintiff has acted with such impropriety that the insolvent's administrators can rely on the equitable maxim that '[h]e who comes into equity must come with clean hands.'<sup>288</sup> The maxim will operate where the impropriety is directly related to the equity alleged by the plaintiff<sup>289</sup> such as misrepresentation,<sup>290</sup> the plaintiff has misled the court,<sup>291</sup> there has been a breach of duty<sup>292</sup> or sexual immorality.<sup>293</sup> It is unclear whether the defence of clean hands is limited to these broad situations and it has been suggested that a precise statement of when the defence of clean hands will be available is necessary.<sup>294</sup> However, the concept of unclean hands should not be limited, otherwise equitable discretion will be unnecessarily fettered. At any rate, it is fairly clear that there are certain situations when the defence will not be available, namely, where the action of the plaintiff is

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<sup>287</sup> (1995) 184 CLR 538.

<sup>288</sup> Meagher, Gummow and Lehane, above n 12, [322].

<sup>289</sup> *Kettles and Gas Appliances Ltd v Anthony Hordern & Sons Ltd* (1935) 35 SR (NSW) 108; *Harrigan v Brown* [1967] 1 NSW 342.

<sup>290</sup> *Hewson v Sydney Stock Exchange Ltd* [1968] 2 NSW 224; *Kettles & Gas Appliances Ltd v Anthony Hordern & Sons Ltd* (1935) 35 SR (NSW) 108.

<sup>291</sup> *Armstrong v Shepherd & Short Ltd* [1959] 2 QB 384, 397 (Lord Evershed MR).

<sup>292</sup> *AG (UK) v Guardian Newspapers Ltd (No 2)* [1990] 1 AC 109.

<sup>293</sup> *Glyn v Weston Feature Film Co* [1916] 1 Ch 261.

<sup>294</sup> Michael Spence, 'Equitable Defences' in Patrick Parkinson (ed), *The Principles of Equity* (1996) 939, [2933].

for the cancellation and delivery of documents,<sup>295</sup> suits for declaratory relief,<sup>296</sup> suits to prevent multiplicity of actions<sup>297</sup> and a suit for statutory relief.<sup>298</sup> If the circumstances do not involve these matters, then *prima facie*, the insolvent should be in a position to successfully raise the defence.

#### 4 *Laches*

The insolvent may be in a position to argue that the plaintiff has unnecessarily delayed bringing an action against the insolvent. Such an argument may not be an easy one to make. A mere delay will not in itself bar a claim.<sup>299</sup> Indeed, generally speaking, equitable proprietary claims are not barred by statutes of limitations. This can be a reason why a party may argue that they have an equitable proprietary interest rather than merely a personal claim. In *Cohen v Cohen*<sup>300</sup> the plaintiff was unable to bring an action for recovery of debt because the action was barred by the relevant Statute of Limitations. Therefore, the plaintiff argued successfully that the defendant held sale proceeds on trust for her because he was required to specifically account for them.<sup>301</sup> Certainly, claims based on undue influence, innocent misrepresentation<sup>302</sup> and breach of fiduciary duty are not so barred.<sup>303</sup> However, it will be necessary to consult the applicable statute of limitations in order to discern whether the action is barred.<sup>304</sup> It is also possible to

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<sup>295</sup> *St John v St John* (1805) 11 Ves Jun 526; 32 ER 1192; *Money v Money (No 2)* [1966] 1 NSW 348.

<sup>296</sup> *Lodge v National Union Investment Co Ltd* [1907] 1 Ch 300.

<sup>297</sup> *Angelelides v James Stedman Henderson Sweets Ltd* (1927) 40 CLR 43; *Dow Securities Pty Ltd v Manufacturing Investments Ltd* (1981) 5 ACLR 501.

<sup>298</sup> *Re the Will of FB Gilbert* (1946) SR (NSW) 318.

<sup>299</sup> See *Baburin v Baburin* [1990] 2 Qd R 101, 112 (Kelly SPJ); Meagher, Gummow and Lehane, above n 12, [3605]-3606; John Brunyate, *Limitation of Actions in Equity* (1932) 260-261.

<sup>300</sup> (1929) 42 CLR 91.

<sup>301</sup> *Ibid* 161-162.

<sup>302</sup> Meagher, Gummow and Lehane, above n 12, [3414].

<sup>303</sup> *KM v HM* [1992] 3 SCR 6; 76-80; (1993) 96 DLR (4th) 289, 333-336 (La Forest J); *Williams v Minister, Aboriginal Land Rights Act 1983* (1994) 35 NSWLR 497.

apply the statute of limitations by analogy,<sup>305</sup> although the courts have the discretion to refuse to follow such an analogy.<sup>306</sup> Delay may also operate as a form of waiver indicating an intention to release an equitable interest or right.<sup>307</sup>

## 5 Hardship

It may be possible for the defendant to argue that the plaintiff's delay in bringing the action will cause hardship on the defendant and accordingly, is unconscionable.<sup>308</sup> Courts have been traditionally hesitant in delineating definitely the scope of the defence or the sorts of situations in which the defence will arise.<sup>309</sup> However, there are some claims where the defence is more successful. Whilst claims by beneficiaries under an express trust have not been generally subject to it<sup>310</sup> (except in a number of discrete cases)<sup>311</sup> other essentially proprietary claims have been subject to the defence.<sup>312</sup> The reason for the difference in approach is that it would be simply unconscionable for a plaintiff to assert an interest in property when a long period of time has passed and the defendant is entitled to assume that he has a proprietary interest in the property or its substitute. The defendant should not be subject to uncertainty over a lengthy period.<sup>313</sup> Indeed, the operation of various

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<sup>304</sup> For legislation which specifically excludes claims for equitable relief on the basis of analogy see: for example *Limitation Act 1969* (NSW) s 23; *Limitation of Actions Act 1958* (Vic) s 5(8); *Limitation of Actions Act 1974* (Qld) s 10(6)(b). For a general discussion of the statute of limitations see Spence, above n 294, [2910].

<sup>305</sup> *Knox v Gye* (1872) LR 5 HL 656, 674 (Lord Westbury).

<sup>306</sup> *KM v HM* [1992] 3 SCR 6; 75; (1993) 96 DLR (4th) 289, 332 (La Forest J); *Williams v Minister, Aboriginal Land Rights Act 1983* (1994) 35 NSWLR 497. See also Denis Browne, *Ashburner's Principles of Equity* (2<sup>nd</sup> ed, 1933) 506 and Spence, above n 294, [2912].

<sup>307</sup> *Orr v Ford* (1988-1989) 167 CLR 316, 338 (Deane J); *Avtex Airservices Pty Ltd v Bartsch* (1992) 107 ALR 539, 567-568 (Hill J).

<sup>308</sup> *Lindsay Petroleum Co v Hurd* (1874) LR 5 PC 221, 239-240 (Sir Barnes Peacock).

<sup>309</sup> *Orr v Ford* (1988-1989) 167 CLR 316, 340-341 (Deane J).

<sup>310</sup> *Ibid.*

<sup>311</sup> *Ibid.*, 341 (Deane J). Note also *Hourigan v Trustees Executors and Agency Co Ltd* (1934) 51 CLR 619 and Meagher, Gummow and Lehane, above n 12, [3606].

<sup>312</sup> *Beckford v Wade* (1805) 17 Ves Jun 87, 97; 34 ER 34, 38 (Sir William Grant MR).

<sup>313</sup> *Fitzgerald v Masters* (1956) 95 CLR 420, 433-434 (Dixon CJ and Fullagar J).

insolvency regimes is likely to limit the period under which a creditor is able to make a claim as a 'secured' creditor by virtue of the intervention of equity. After a certain period, usually three years, the insolvent is entitled to a discharge from insolvency.<sup>314</sup>

## 6 Contributory Negligence

Another possible defence, which relates directly to proprietary relief, is that the plaintiff contributed to his unfortunate financial position in relation to the insolvent. It has already been demonstrated that a failure to inspect public records or take security may seriously undermine a plaintiff's case where such conduct is part of a conventional risk minimisation strategy.<sup>315</sup> However, these issues have been discussed from the perspective of what a plaintiff must prove. However, the context here is what defences the insolvent may raise in relation to the plaintiff's pre-transactional conduct. Although there is an overlap between commercial expectations of risk minimisation and a potential defence of contributory negligence, they remain different. Commercial expectations of risk minimisation emphasises the need for the plaintiff to establish the commercial milieu in which the transaction took place. On the other hand, the defence emphasises the plaintiff's neglectful action or omission.

The question is whether a broader notion of negligence may become relevant. It is tempting to use the phrase 'contributory negligence' in this context. Contributory negligence has been defined as:

a plaintiff's failure to meet the standard of care to which he is required to conform for his own protection and which is a legally contributing cause, together with the defendant's default, in bringing about his injury.<sup>316</sup>

Contributory negligence arises in tort actions where the defendant owes the plaintiff a standard of care to which the defendant does not conform. The plaintiff brings an action in negligence against the defendant who, in turn, argues that the plaintiff himself, through his own fault, contributed to his own injury.<sup>317</sup> Whilst the concept

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<sup>314</sup> For a discussion of discharge from bankruptcy see: *Bankruptcy Act 1966* (Cth) Part VII particularly ss 149 and 149A and *McQuade and Gronow*, above n 57, [149.0]-[149A.3.05].

<sup>315</sup> Chapter 6, 214-218.

<sup>316</sup> John G. Fleming, *The Law of Torts* (9<sup>th</sup> ed, 1998) 302.

<sup>317</sup> *Ibid* 302, 318-320.

of contributory negligence was developed in tort cases, it can be assimilated into some commercial cases where proprietary relief is sought. Whilst it could not be said that the defendant owed the plaintiff a formal duty of care, it is arguable that equity is moving towards formalised duties such as requirements of disclosure in certain circumstances.<sup>318</sup>

Here, two distinct questions arise. First, is it appropriate on a theoretical level that courts exercising equitable jurisdiction seriously consider arguments based on contributory negligence? Some authors argue that the common law courts (as distinct from Chancery) engaged in an exploration of such issues as contributory negligence. Customarily, equity has awarded remedies without undertaking an inquiry into whether the acts or omissions of the plaintiff were at least in part responsible for the loss suffered.<sup>319</sup> Other authors have cautiously welcomed the potential for enfusing equitable relief with common law criteria so long as the exercise is undertaken on a principled basis.<sup>320</sup>

However, courts exercising equitable jurisdiction did consider whether the conduct of the plaintiff itself contributed to the unfortunate position. Indeed, this has been an important issue in priority claims between equitable interests.<sup>321</sup> In addition, there is also authority which suggests that the notion of contributory negligence may be pleaded where equitable relief is sought. For example, in *Day v Mead*,<sup>322</sup> Cooke P held that in an action for breach of fiduciary duty, contributory negligence on the

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<sup>318</sup> In relation to duties of care and disclosure note the effect of such cases as *Commonwealth Bank of Australia v Smith* (1991) 102 ALR 453; *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447; *Waltons Stores (Interstate) Ltd v Maher* (1988) 164 CLR 389; *Garcia v National Australia Bank Ltd* (1998) 155 ALR 614.

<sup>319</sup> The Hon. Mr Justice Gummow, 'Compensation for Breach of Fiduciary Duty', in TG Youdan (ed) *Equity, Fiduciaries and Trusts* (1989) 57, 82-87; Paul W Michalik, 'The availability of compensation and exemplary damages in equity: A note on the Aquaculture decision (1991) 21 *Victoria University of Wellington Law Review* 391. Note also the dissenting judgment of McLachlin J in *Canson Enterprises Ltd v Boughton & Co* 85 (1992) DLR (4th) 129, 154-164.

<sup>320</sup> Lee Aitken, 'Developments in Equitable Compensation: Opportunity or Danger?' (1993) 67 *Australian Law Journal* 596; Charles Rickett and Tim Gardner, 'Compensating for loss in equity: The evolution of a remedy' (1994) 24 *Victoria University of Wellington Law Review* 19; Charles Rickett, 'Equitable Compensation: The Giant Stirs' [1996] 112 *The Law Quarterly Review* 27.

<sup>321</sup> *Abigail v Lapin* (1934) 51 CLR 58; *Breskvar v Wall* (1972) 126 CLR 376; Parkinson and Wright, above n 256, [319].

<sup>322</sup> [1987] 2 NZLR 443.

part of a plaintiff would directly affect the assessment of the loss sustained by the plaintiff on the basis of the fusion of law and equity.<sup>323</sup> Unfortunately, where fiduciary obligations are concerned, the interpolation of the concept of contributory negligence appears somewhat antithetical to the concept of fiduciary obligations. But perhaps, the answer lies in the fact that in such cases as *Day v Mead*, the nature of the non-assumption of risk was not as extensive as in traditional trust and fiduciary cases.

Secondly, is the concept of a contributory negligence an appropriate basis for a defence against an action for proprietary relief? If the plaintiff could show that he could not have objectively assumed the risk, the plaintiff should be entitled to proprietary relief. In cases concerned with mistake, it has been accepted by courts that the negligence of the plaintiff will not preclude recovery.<sup>324</sup> However, in relation to other vitiating factors such as void and voidable contracts, the position is far from clear.

There are good reasons for courts carefully examining the extent to which (if at all) the neglectful actions or omissions of the plaintiff have contributed to its unsecured status. Such an approach is consistent with the attitude of the courts to inspection of public registers.<sup>325</sup> A plaintiff should not be able to obviate his own responsibility for protecting his interests. Otherwise, the grant of proprietary relief may assist a blatantly neglectful plaintiff. Also, it should not be forgotten that a plaintiff who seeks proprietary relief is seeking to establish priority over other creditors, principally unsecured creditors. It would be inequitable to elevate one unsecured creditor (who had acted neglectfully) to a secured status, whilst another unsecured creditor did not have an opportunity to take security. Indeed, in the exercise of equity's substantial discretionary jurisdiction, a court must be entitled to weigh up the conduct of the parties. Traditionally, when providing relief, equity has examined the conduct of the person seeking that relief.<sup>326</sup>

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<sup>323</sup> Ibid 451; Note also *Canson Enterprises Ltd v Boughton & Co* (1992) 85 DLR (4th) 129, 132 (La Forest J, Sopinka, Gonthier and Cory JJ concurring). cf *Hill v Rose* [1990] VR 129; *Carl B Potter Ltd v Mercantile Bank of Canada* (1980) 112 DLR (3d) 88.

<sup>324</sup> *Kelly v Solari* (1841) 9 M & W 54; 152 ER 24.

<sup>325</sup> *Re Ayoub; ex parte Silvia* (1983) 67 FLR 144, 148-149 (Morling J).

<sup>326</sup> For example see specific performance cases: *King v Poggioli* (1923) 32 CLR 222; *Gurney v Gurney (No 2)* [1967] NZLR 922.

There are two kinds of conduct which may be relevant to a defence of contributory negligence. One form of conduct is where the plaintiff made certain assumptions about the transactions which were unwarranted. Here, the plaintiff may have made assumptions concerning the capacity of the defendant to enter into a contract<sup>327</sup> or the inherent validity of the contract or obligations contained therein.<sup>328</sup> Whether the plaintiff failed to investigate to the degree necessary to protect its own interest will ultimately be a matter of fact. Certainly, large commercial enterprises with the finances and human resources to undertake factual and legal enquiries may not be successful in the light of their own investigatory neglect. Surely, for example, large commercial enterprises are able to make appropriate investigations to ensure that the transactions which they commonly enter are not rendered void or voidable by statute. In comparison, the small consumer has neither the time nor resources to undertake such investigations. Nonetheless, there will be occasions where the assumption made by even a large commercial enterprise will be so widespread that the failure to investigate further should not be interpreted as neglect. In *Westdeutsche*<sup>329</sup> the plaintiff had entered into a swap arrangement with the defendant council. Later, it had been held by the House of Lords<sup>330</sup> that such interest rate swaps were ultra vires the powers of local councils. At the time, the plaintiff entered into the interest rate swap, it was commonly assumed that local councils had the capacity to enter into such commercial arrangements. The fact that the plaintiff made such a commonly held market assumption was not evidence that the plaintiff had failed to protect its financial interests.

The other form of neglect which will inevitably contribute to a plaintiff's status as an unsecured creditor is where the plaintiff acquires an ineffective security from the insolvent. As the plaintiff has sought security from the defendant (in conformity with commercial norms), it is part of the plaintiff's responsibility to ensure that the security is valid in all respects.

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<sup>327</sup> *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669; *Sinclair v Brougham* [1914] AC 398.

<sup>328</sup> *David Securities Pty Ltd v Commonwealth Bank* (1992) 175 CLR 353.

<sup>329</sup> [1996] AC 669.

<sup>330</sup> *Hazell v Hammersmith and Fulham London Borough Council* [1992] 2 AC 1.

## 7 Passing on Risk to Customers<sup>331</sup>

The defence of passing on of risk has arisen in the context of the law of restitution. It has been described as arising:

when the plaintiff shifts on to a third party the financial burden that is consequent upon the defendant's unjust gain. Thus, in the most common scenario, a business purportedly liable for a tax makes payment to the government, but also attempts to recoup its loss by raising the prices that it charges to its customers. When the tax is determined to be improper or inapplicable, the business seeks restitutionary relief. The government resists that claim on the basis that its enrichment came not at the plaintiff's expense, but rather at the expense of the plaintiff's customers.<sup>332</sup>

There have been a series of recent decisions in which courts have rejected or questioned the merits of the defence.<sup>333</sup> It is argued that restitution is concerned with restoring what belongs to a plaintiff rather than ascertaining the ultimate loss.<sup>334</sup> Even if the defence of passing on of risk is theoretically acceptable,<sup>335</sup> in practical terms it is very difficult to give effect to and to prove.<sup>336</sup> The operation of a defence based on passing on of risk means that a plaintiff will be left without any remedy.

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<sup>331</sup> For a discussion of the defence see Burrows, above n 281, 476-477; W Woodward, 'Passing-on' the Right to Restitution' (1985) 39 *University of Miami Law Review* 873; P Mitchell, 'Restitution, 'Passing On' and the Recovery of Unlawfully Demanded Taxes: Why Air Canada Doesn't Fly' (1995) 53 *University of Toronto Faculty Law Review* 130; Francis Rose, 'Passing On' in Peter Birks (ed), *Laundering and Tracing* (1995) 261; JD Merrells, 'Restitutionary Recovery of Taxes After the Royal Insurance Case' in Mitchell McInnes (ed), *Restitution: Developments in Unjust Enrichment* (1996); John Glover, 'Restitutionary Recovery of Taxes After the Royal Insurance Case: Commentary' in Mitchell McInnes (ed), *Restitution: Developments in Unjust Enrichment* (1996) 131.

<sup>332</sup> Mitchell McInnes, 'Passing On' in the Law of Restitution: A Re-Consideration' (1997) 19 *The Sydney Law Review* 179, 179.

<sup>333</sup> *Kleinwort Benson Ltd v Birmingham City Council* [1996] 3 WLR 1139; *Woolwich Equitable Building Society v Inland Revenue Commissioners* [1993] AC 70 at 177-178 (Lord Goff); *Air Canada v British Columbia* [1989] 1 SCR 1161; (1989) 59 DLR (4th) 161; *Commissioner of State Revenue (Vic) v Royal Insurance Australia Ltd* (1994) 182 CLR 51, 69-79 (Mason CJ).

<sup>334</sup> *Commissioner of State Revenue (Vic) v Royal Insurance Australia Ltd* (1994) 182 CLR 51, 73 (Mason CJ).

<sup>335</sup> McInnes, above n 332, 183-193.

<sup>336</sup> *Ibid* 199-203; *Commissioner of State Revenue (Vic) v Royal Insurance Australia Ltd* (1994) 182 CLR 51, 72 (Mason CJ).



It appears that the defence has not been raised in cases where the plaintiff has been seeking proprietary relief. This is understandable in the sense that in the past, plaintiffs have asserted that they have retained a proprietary interest in the funds which were the subject of the dispute. The passing on of risk defence arises in cases where it is accepted that the defendant has acquired title to the funds and the defendant wishes to deflect the vitiation of the transaction on the basis that the plaintiff has a large consumer base upon which to pass on risk.

However, it is one of the main contentions of the thesis that in the future, proprietary relief will no longer depend solely upon tracing and reification of money. Therefore, a defence based on passing on of risk to customers could be raised where a proprietary claim has been made, particularly on the basis that the passing on of risk is a form of risk minimisation. The question will be what attitude the courts should take.

There are several reasons why courts should take a cautious approach. First, such a defence would work in favour of the insolvent and the general unsecured creditors to the detriment of a plaintiff. Even if it were proved that the plaintiff had paid over funds pursuant to undue influence or a genuine mistaken belief, the insolvent and the unsecured creditors would have access to these funds on the basis that the plaintiff had an opportunity to pass on the risk to its customers.

Secondly, the defence would not only operate effectively against arguments that the plaintiff should receive a proprietary and priority status. Arguably, it would also undercut the claims of a plaintiff as an unsecured creditor. The effect of the defence in an insolvency context is that the plaintiff loses a right and remedy to recover even a rateable proportion of the funds which it claims against the defendant. This would enhance the position of the defendant insolvent and the capacity of that insolvent to repay its other creditors.

Thirdly, such a defence could be used ruthlessly against plaintiffs which have the capacity to pass on business costs to customers. The problem is that it is difficult (if not impossible) to prove that such losses have been passed onto customers. Moreover, the underlying assumption of the defence is that it is commercially feasible for plaintiffs to pass on losses to their customers. In a highly competitive

market this may be impossible to achieve because of the underlying elasticity and efficiency of the market in which the plaintiff operates.<sup>337</sup>

Fourthly, no doubt part of the day to day operation of business is that the more profitable transactions will offset less profitable or even loss creating transactions. However, it is not clear whether unsuspecting customers should have the risk of the insolvency effectively passed onto them. The position of the customers is qualitatively very different from the credit insurer who consciously undertakes to accept the risk of insolvency of another.<sup>338</sup>

## ***B Defences Based on the Conduct of the Insolvent as Defendant***

### ***1 Introduction***

The issue here is to what extent should an insolvent (or the insolvent's administrators) argue that courts should take into account the subsequent actions of the insolvent when a plaintiff seeks proprietary relief. Two important defences are possible.

### ***2 Any Wrongdoing is not Attributable to the Insolvent's Administrators***

Under the rule in *Ex parte James; Re Condon*<sup>339</sup> the trustee in bankruptcy cannot rely on taking full advantage of his legal rights and in the case of property, the trustee may be ordered to return the money which he may have collected.<sup>340</sup> In subsequent cases, judges have indicated a willingness to exercise equitable jurisdiction in order to ensure that the party who effects the administration of the

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<sup>337</sup> See generally the issues raised in SG Corones, *Restrictive Trade Practices Law* (1994) [1-01]-[1-13].

<sup>338</sup> Chapter 6, 220-222.

<sup>339</sup> (1874) LR 9 Ch 609. See also Chapter 1, 34-35.

<sup>340</sup> Muir Hunter and David Graham, *Williams and Muir Hunter: The Law and Practice in Bankruptcy* (19<sup>th</sup> ed, 1979) 249-254.

insolvent's estate, acts in such a way as to ensure that there has been honest dealing.<sup>341</sup>

Unfortunately, the rule appears to be both circumscribed and in decline.<sup>342</sup> It has been circumscribed in the sense that it is only available to a claimant who is unable to submit an ordinary proof of debt.<sup>343</sup> The explanation of the restriction is that:

The rule is not to be used merely to confer a preference on an otherwise unsecured creditor, but to provide relief for a person who would otherwise be without it.<sup>344</sup>

Where a party is not able to submit an ordinary proof of debt, such as a wife in family court proceedings,<sup>345</sup> the party may be successful. But many if not most unsecured creditors in the commercial context will not fulfil this requirement. Therefore, they will not be able to rely on the rule in *Ex parte James*.

This can be seen as another manifestation of the principle of rateable distribution.<sup>346</sup> The problem is that a creditor may be in a position to seek a second insolvency, but the assets which the insolvent had acquired from them are used to

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<sup>341</sup> For examples of where the principle has been referred to with approval or applied: *Re Craig & Sons: Ex parte Hinchcliffe* [1916] 2 KB 497; *Re Thelluson; Ex parte Abdy* [1919] 2 KB 735; *Re Regent Finance & Guarantee Corp* [1930] WN (Eng) 84; *Re Henderson; Ex parte Tonkin* (1934) 7 ABC 273; *Re Docker; Ex parte Official Receiver* (1938) 10 ABC 97; *Re Roberts; Official Receiver v Lincoln Investments Ltd* (1976) 26 FLR 330. *Re Wyvern Developments Ltd* [1974] 1 WLR 1097.

<sup>342</sup> For examples where the principle has not been applied see *Re Hall: Ex parte Official Receiver* [1907] 1 KB 875; *Tapster v Ward* (1909) 101 LT 503; *Re Stokes; Ex parte Mellish* [1919] 2 KB 256; *Re Wigzell; Ex parte Hart* [1921] 2 KB 835; *Official Assignee of Turnbull's Estate v Goldstein* (1921) 29 CLR 377; *Scranton's Trustee v Pearse* [1922] 2 Ch 87; *Re Wilson; Ex parte Salaman* [1926] Ch 21; *Re Gozzett; Ex parte Messenger & Co Ltd v The Trustee* [1936] 1 All ER 79; *Re De Wit; Ex parte Custom Credit Corporation Ltd; Official Receiver* (1961) 19 ABC 63; *Re Roberts; Official Receiver v Lincoln Investments Ltd* (1976) 26 FLR 330; 12 ALR 730; *Re Byfield (a bankrupt); Ex parte Hill Samuel & Co Ltd v Trustee of the Property of the Bankrupt* [1982] Ch 267.

<sup>343</sup> *Hunter and Graham*, above n 340, 250; *Re Clark (A Bankrupt); Ex parte The Trustee v Texaco Ltd* [1975] 1 WLR 559; *Re Ayoub; Ex parte Silvia* (1983) 67 FLR 144; *Re Sabri; Ex parte Brien v Australia and New Zealand Group Ltd* [1996-1997] 21 Fam LR 213.

<sup>344</sup> *Ibid.*

<sup>345</sup> *Re Ayoub; Ex parte Silvia* (1983) 67 FLR 144; *Re Sabri; Ex parte Brien v Australian & New Zealand Banking Group Ltd* [1996-1997] 21 Fam LR 213.

<sup>346</sup> Chapter 1, 32-34.

pay debts under the first insolvency. Under the second insolvency there are no assets to start with.<sup>347</sup> It is also necessary to show that the assets of the insolvent have been enriched.<sup>348</sup> However, what is meant by enriched is not clear.

It has been also held that the rule is only applicable where the acts or omissions of the insolvent are attributable to the administrator. Thus, even if the property is traceable, the courts have not always been willing to accede to proprietary claims.<sup>349</sup>

This form of defence has the prima facie effect of ensuring that the insolvent's estate remains augmented. It is antithetical to the swollen assets theory<sup>350</sup> and artificially segregates the activities of the insolvent from the actions of the administrators. The result is a perverse accretion of additional assets for distribution amongst the other unsecured creditors. It may well be that in the future, analysis will shift focus on whether the plaintiff took the risk as was considered in *Re Ayoub; ex parte Silvia*.<sup>351</sup> Such an analysis would concentrate on the dual issues of risk assumption and the insolvent's unconscionable conduct rather than the artificial segregating of assets.

### 3 Change of Position

The defence of change of position is allied to the traditional defence of delay in the sense that both defences highlight that it would be unconscionable to impose liability on the defendant in the light of the defendant's changed circumstances.<sup>352</sup> The defence is also allied to estoppel<sup>353</sup> because both defences require evidence that the defendant has acted to his own detriment on the faith of the receipt. However, the

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<sup>347</sup> *Re Ayoub; Ex parte Silvia* (1983) 67 FLR 144.

<sup>348</sup> Hunter and Graham, above n 340, 250.

<sup>349</sup> See for example *Re Wigzell; Ex parte Hart* [1921] 2 KB 835; *Downs Distributing Co Pty Ltd v Associated Blue Star Stores Pty Ltd (in liq)* (1948) 76 CLR 463, 483-484 (Williams J); *Westpac v Markovic* (1985) 82 FLR 7, 11 (Zelling J).

<sup>350</sup> Chapter 4, Part IV.

<sup>351</sup> (1983) 67 FLR 144, 148-149 (Morling J).

<sup>352</sup> *Lipkin Gorman (A Firm) v Karpnale Ltd* [1991] 2 AC 548, 579-580 (Lord Goff).

<sup>353</sup> Mason and Carter, above n 12, [2404], [2406]-[2409].

defence of estoppel is generally more difficult to prove because a collateral representation has generally been required in order to successfully plead estoppel.<sup>354</sup> A representation that a defendant was entitled to money cannot be implied from the payment itself. The change of position defence also differs from estoppel in the sense that change of position is activated by the fact that the defendant has changed his or her position on the faith of the receipt (rather than the active representation of the plaintiff).<sup>355</sup>

The defence of change of position is a powerful tool. A defendant who is able to avail himself of the defence, would, on the basis of his own actions in good faith, preclude the plaintiff of a personal remedy. Presumably, if the plaintiff was precluded from obtaining personal relief, then it would be unlikely that a court would provide proprietary relief. In an insolvency context, this would mean that the plaintiff would not even sustain the status of an unsecured creditor.

The defence of change of position has been recognised in the law of restitution.<sup>356</sup> Whilst some of the features of the defence of change of position remain unclear and unsettled,<sup>357</sup> certain criteria must be fulfilled. In order to activate the defence, a defendant must show that expenditures have been made on the basis that the payment was valid. The defendant must have acted in good faith and the defence is not open to wrongdoers.<sup>358</sup> Therefore, it is unlikely that the defence would be

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<sup>354</sup> *National Mutual Life Association v Walsh* [1987] 8 NSWLR 585, 596-598 (Clarke J).

<sup>355</sup> Mason and Carter, above n 12, [2409].

<sup>356</sup> *David Securities Pty Ltd v Commonwealth Bank of Australia* (1992) 175 CLR 353; *Lipkin Gorman (A Firm) v Karpnale Ltd* [1991] 2 AC 548; *State Bank of New South Wales v Swiss Bank Ltd* (1995) 39 NSWLR 350.

<sup>357</sup> See for example Goff and Jones, above n 13, Chapter 40; Burrows, above n 281, 421-431; Peter Birks, 'Change of Position: The Nature of the Defence and its Relationship to Other Restitutionary Defences' in Mitchell McInnes (ed), *Restitution: Developments in Unjust Enrichment* (1996) 49; Michael Bryan, 'Change of Position: Commentary' in Mitchell McInnes, *Restitution: Developments in Unjust Enrichment* (1996) 75; Damien O'Brien, 'Change of Position: The Past, the Present and the Future' (1995) 25 *Queensland Law Society Journal* 511; Paul Key, 'Change of Position' (1995) 58 *The Modern Law Review* 505; M McInnes, 'The Defence of Change of Position in the Law of Restitution,' (1996) *Australian Business Law Review* 313; Tina Cockburn, 'Restitution: The Defence of Change of Position After David Securities' (1994) 24 *Queensland Law Society Journal* 95; Robert Chambers, 'Change of Position on the Faith of the Receipt' (1996) 4 *Restitution Law Review* 103; Richard Nolan, 'Change of Position' in Peter Birks (ed) *Laundering and Tracing* (1995) 6.

<sup>358</sup> *Lipkin Gorman (A Firm) v Karpnale Ltd* [1991] 2 AC 548, 579 (Lord Goff); Mason and Carter, above n 12, [2419].

available to defendants who have, prior to the transaction, acted unconscionably.<sup>359</sup> However, it is not surprising that the defence has been pleaded in other situations where the defendant could be expected to rely on the validity of the payment, such as where the plaintiff mistakenly made a payment to the defendant.<sup>360</sup>

The defence will not be available simply on the basis that the defendant has made an expenditure. The defendant will have to show that the defendant spent the money solely on the basis of the receipt and that it is unlikely that the expenditure would have been made without it.<sup>361</sup> The defence is not available where the funds have been spent on ordinary living expenses,<sup>362</sup> so that the expenditure must be made on extraordinary, as distinct from ordinary, items. It is unclear at this stage whether the defendant must precisely identify the expenditure made with the receipts<sup>363</sup> or whether the defence will operate so long as the funds have been expended<sup>364</sup> (although the latter is to be preferred). The defence operates pro tanto.<sup>365</sup> Therefore, it is only an effective defence to the extent that the defendant has expended the funds solely on the basis of the receipt on extraordinary items.

Despite the need for further clarification of the precise parameters of the defence, courts should take a cautious attitude. Certainly, the defence should only be available in situations where the insolvent has arguably acted unconscionably after the commercial transaction commenced.

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<sup>359</sup> See the note written by Peter Butler in [1993] *Restitution Law Review* 55, § 18 on *Mercedes-Benz (NSW) Pty Ltd v ANZ and National Mutual Royal Savings Bank* (Unreported judgment of 5 May, 1992, 48-49 Palmer JA).

<sup>360</sup> *David Securities Pty Ltd v Commonwealth Bank of Australia* (1992) 175 CLR 353.

<sup>361</sup> *Lipkin Gorman (A Firm) v Karpnale Ltd* [1991] 2 AC 548, 580 (Lord Goff).

<sup>362</sup> *Ibid*; *David Securities Pty Ltd v Commonwealth Bank of Australia* (1992) 175 CLR 353, 385-386 (Mason CJ, Deane, Toohey, Gaudron and McHugh JJ).

<sup>363</sup> See the discussion in *Rural Municipality of Storthoaks v Mobil Oil Canada Ltd* (1975) 55 DLR (3d) 1, 13 (Martland J).

<sup>364</sup> *Moritz v Horsman* 9 NW (2d) 868 (SC Michigan, 1943).

<sup>365</sup> *Lipkin Gorman (A Firm) v Karpnale Ltd* [1991] 2 AC 548, 580-581 (Lord Goff).

## VI CONCLUSION

In this chapter, the two remaining parts of the theory of objective non-assumption of risk were considered, namely, the proprietary remedy and possible defences.

It was argued that, generally speaking, the appropriate proprietary remedy for objective non-assumption of risk would be a general equitable lien over the assets of the insolvent. Such a lien would represent a new development and extension of the kinds of equitable charges and liens in our legal system. It would also give effect to doctrinal developments inherent in the adoption of the theory of objective non-assumption of risk.

As a theoretical construct, a general equitable lien has not been tested in the courts. And, as the discussion in this chapter indicates, there are a number of substantive issues which arise from the practical application of a general equitable lien. However, these practical issues must be faced and not simply dismissed. As modern commercial transactions become more complex and equitable tracing becomes increasingly impractical, new remedial responses to unconscionable conduct need to be found. The general equitable lien is not undermined by the fact that practical and doctrinal problems still need to be worked through. Rather, these problems indicate that traditional remedial responses to unconscionable conduct are in urgent need of review. Thus, the application of the general equitable lien represents the culmination of the application of the theory of objective non-assumption of risk and the discussion foreshadows that courts and commentators will continue to identify salient issues.

The same can be said about the defences discussed. Equity has countenanced defences to actions based on unconscionable conduct and there is no reason why such defences should not be available where a plaintiff claims objective non-assumption of risk. The parameters and workability of some of the defences considered are still to be worked out. This will become important as claims for proprietary relief continue to be made.

In this and the previous two chapters, the underlying rationale and practical application of the theory of objective non-assumption of risk were discussed. The conclusion summarises the thesis and considers the potential impact of the theory of objective non-assumption of risk.

## **CONCLUSION: EQUITY'S DOMAIN**



## I INTRODUCTION

The focus of this thesis has been the issue of how and when proprietary relief should be available where one party has transferred money or goods for sale to a party who becomes insolvent. It is contended that this issue can no longer be simply answered by recourse to traditional proprietary rules and legal mechanisms.

Modern capitalism is transacted in a more sophisticated way than in 19th century England. In particular, technological developments have challenged traditional forms of money, the way that money is transferred between parties and the characterisation of commercial relationships. Just as Lord Mansfield was required to innovatively respond to the legal issues created by the way 18th century commerce was transacted, so too, we are challenged to creatively and carefully respond to commercial change. Without a careful response at this stage, our legal system will be unable to cope with the further and likely changes in the 21st century.

Fortunately, today legislatures and judges alike are less reticent about intervening in commercial transactions than their counterparts in the 19th century. Some of the flaws of an untrammelled capitalist system from a legal perspective were highlighted in Chapter 1.<sup>1</sup> Therefore, even though a particular commercial situation does not fall within traditional characterisations or certain traditional rules cannot be applied, courts should not be precluded from providing relief in otherwise arms-length transactions. However, any such proprietary intervention must be undertaken on a principled and legally justifiable basis.

## II UNSECURED CREDITORS

The basic context is that a creditor transfers money or goods for sale to a party who becomes insolvent. The creditor is unsecured. Without the existence of a traditional security device, the creditor will stand behind preferred and unsecured creditors. From the unsecured creditor's perspective, the practical effect can be catastrophic. At the end of the day, there may be insufficient assets available to partly or fully pay out the unsecured creditors. Therefore, a unsecured creditor will try and argue that despite his unsecured status, he should be accorded a secured status because of the nature and circumstances of the transaction. If such arguments were accepted each time an unsecured creditor sought a secured and preferential

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<sup>1</sup> Chapter 1, 20-22.

status, the way that transactions were legally effected and the administration of insolvencies would be uncertain and chaotic.

One way of dealing with this problem is to assert that notwithstanding the nature of and the circumstances surrounding the transaction, an unsecured creditor cannot be accorded a higher secured and preferred status. It could be argued that such insolvency regimes such as the *Bankruptcy Act 1966* (Cth) do not contain a specific provision which empowers courts to elevate the unsecured creditor to a secured or preferred status. Therefore, the concept of an unsecured creditor should remain a unitary concept and administrators and courts alike should not be entitled to investigate and consider the reasons why a party was an unsecured creditor. However, this approach is not tenable.

As previous discussion has highlighted,<sup>2</sup> there are some specific cases where legislatures have singled out unsecured creditors for special and preferred treatment. Such unsecured creditors are accorded a preferred status which entitles them to stand ahead of all other unsecured creditors. Although the list is a relatively small one, it is necessary for the operation of such insolvency regimes. Otherwise, insolvency regimes would operate unfairly against administrators and employees.

It has also been noted that insolvency regimes such as the *Bankruptcy Act 1966* (Cth) do not preclude the operation of the general law, particularly equity, where appropriate. The legislation recognises equitable mechanisms such as the trust<sup>3</sup> and equitable securities such as the equitable lien.<sup>4</sup> Moreover, the legislation specifically states that courts may make such orders, including equitable remedies, as the court thinks fit.<sup>5</sup> Therefore, the legislation does not preclude an order for equitable proprietary relief, where the court considers that such an order is necessary. Whether such relief is warranted, depends upon the general law rather than the terms of the legislation.

Moreover, courts exercising equitable jurisdiction have made it clear that where necessary, they will intervene in insolvency situations to ensure administrators

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<sup>2</sup> Chapter 1, 33; Chapter 7, 323-324.

<sup>3</sup> *Bankruptcy Act 1966* (Cth) s 116 (2) (a).

<sup>4</sup> *Bankruptcy Act 1966* (Cth) s 5.

<sup>5</sup> *Bankruptcy Act 1966* (Cth) s 30 (1) (b).

do not unfairly incorporate property into the insolvent's asset base which does not properly belong to the insolvent.<sup>6</sup>

To treat unsecured creditors as an undifferentiated mass of creditors is to fail to acknowledge that there are a variety of reasons why such creditors may be unsecured. Therefore, whilst in most cases the unsecured creditor is and can only remain unsecured, there will be a relatively small number of cases where the creditor has a legitimate argument that he should be elevated to a secured and preferential status. The simple division between secured and unsecured creditors which is so entrenched in property law and insolvency administration, is an inadequate bifurcation of creditor status in these kinds of cases.

Another way of dealing with this problem is to acknowledge that our legal system does elevate unsecured creditors to a preferred status in a limited range of cases. Indeed, the discussion throughout Chapter 2 illustrated the kinds of mechanisms which equity has used to do so. Our 19th century legal heritage has been helpful in determining when proprietary interests exist or where proprietary relief should be available. However, the underlying substratum of commercial contexts and technological innovation has rendered existing methodologies inadequate in a small but significant group of cases. The kinds of situations where proprietary relief is necessary were illustrated in Chapter 6.

### III THE ROLE AND RATIONALE OF EQUITY

Having located that a relatively small group of unsecured creditors may argue that they should be accorded a secured status as against other unsecured creditors, it is necessary to consider how and on what basis that preferential status ought to be achieved. In general terms, where a party is initially unsecured, a secured status is established by the recognition of, or the award of, proprietary relief in the form of a trust or equitable lien - both creations of equitable jurisdiction. Thus, it has been contended throughout this thesis that both the rationale for proprietary intervention and the mechanisms for intervention will be derived from equity. The principal reason for such an assertion is that equity, rather than the common law, has developed and sustained proprietary mechanisms which have effectively operated in insolvency situations. Although this thesis did not discuss at length the traditional equitable securities (such as the equitable mortgage and the equitable charge), it is

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<sup>6</sup> *Ex parte James; Re Condon* (1874) LR 9 Ch App 609.

important to emphasise that these kinds of securities have formed the basis for the development of sophisticated and complex commercial security arrangements<sup>7</sup>. In addition, the trust in its various forms which is not recognised as a security device,<sup>8</sup> has important security implications. It splits ownership between two separate parties, so that if the trustee becomes insolvent, the assets subject to the trust are not available for distribution amongst the creditors of the trustee.<sup>9</sup> Having identified important equitable mechanisms, it has been argued that it is necessary to analyse the modern rationale for these mechanisms. By doing so, it is possible to determine what further kinds of cases equity will avail proprietary relief.

At this time, there appears to be no single justification for the recognition and award of proprietary relief in equity. This could be interpreted as indicating that the theoretical basis of equity is confused and uncertain. However, this is not an interpretation consistent with this thesis. Rather, it was pointed out in Chapter 1 that equity is undergoing a period of renewal and transformation. Its profound interaction with, and intervention in, commercial relationships has meant that, equity has not only progressed from its ecclesiastical origins to a secular jurisdiction, but that the operation of the modern secular jurisdiction is becoming commercially orientated and clearer.

At this point, there are possibly five approaches for governing the application of equitable proprietary mechanisms. All of these interpretations have surfaced for discussion throughout the thesis and it is appropriate to identify and juxtapose them for the purpose of the conclusion.

A first approach is to argue that equitable proprietary mechanisms and intervention should be limited to the narrowly defined and pre-existing traditional categories of equitable proprietary relief. The kinds of mechanisms which fall within the traditional purview were discussed in Chapters 1 and 2. Therefore, traditional equitable securities such as equitable mortgages and charges are the product of mutual intention and operate in favour of mortgagees and chargees to secure them against the insolvency of the mortgagor or chargor. Equitable proprietary relief

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<sup>7</sup> See generally, Edward I Sykes and Sally Walker, *The Law of Securities*, (5<sup>th</sup> ed, 1993), Chapter 7; William James Gough, *Company Charges* (2<sup>nd</sup> ed, 1996).

<sup>8</sup> Sykes and Walker, above n 7, 12.

<sup>9</sup> *Bankruptcy Act 1966* (Cth) s 116 (2) (a); DWM Waters, *Law of Trusts in Canada*, (2<sup>nd</sup> ed, 1984) 13-14.

would be available to remedy breach of fiduciary duty and in accordance with certain specific equitable doctrines. But, even here it should be noted that not all fiduciary relationships extend proprietary protection.

The advantage of this approach is that the criteria for equitable proprietary mechanism and equitable proprietary relief is clear and limited to apparently traditional modes of equitable intervention. However, such an approach is flawed. It does not take into account the modern context such as changing technological underpinnings and the faster pace in which commercial transactions take place. It does not posit how equity should respond to commercial change. It suffers from an overall sense of incoherence - there is no overarching principle which binds equitable intervention together - except perhaps, a reference to the need to prevent unconscionable conduct. Therefore, there is no meaningful and systematic principle which may be applied to determine the nature and possible further extent of equitable intervention in the future. Essentially, it utilises equitable proprietary securities and equitable proprietary relief in an entirely mechanical way. The danger of this approach is that the dynamics and flexibility of equity in its original and modern form are lost.

A second approach is to describe the existence of equitable mechanisms on the basis of mutual intention or equitable wrongdoing narrowly defined. This approach is similar to the first one - except that it allows a party which stands outside traditional categories to access proprietary relief where there has been equitable wrongdoing in a narrow sense. Again, traditional equitable securities operate in favour of mortgagees and chargees to secure them against the insolvency of the mortgagor or chargor. Where there is no mutual intention to create a security, then the unsecured creditor has three options open to it. The unsecured creditor may be able to show a trust or fiduciary duties regulate the relationship and impact upon the distribution of assets in an insolvency. Another option is that he may be able to access certain specific traditional equitable doctrines which entitle him to proprietary relief such as subrogation or marshalling. The final option open to the creditor is that he may be able to establish that the insolvent was guilty of wrongdoing in the sense that prior to or at the time of the transaction, the insolvent acted unconscionably. So, for example, the unsecured creditor may be able to establish that he is entitled to proprietary relief because there were fraudulent misrepresentations before the contract was entered into or the gift was the product of the undue influence of the insolvent. This approach is consistent with the majority decision in *Westdeutsche*

*Landesbank Girozentrale v Islington London Borough Council*.<sup>10</sup> The advantages and disadvantages of this interpretation are similar to those identified in the first interpretation, except that the underlying principle of equity is utilised more effectively.

A third approach is that equity cannot provide a coherent principle for the use of equitable proprietary mechanisms. This interpretation is connected to the first interpretation in one fundamental aspect. Both interpretations are more concerned with utilising equitable proprietary relief rather than connecting them to a coherent modern rationale explaining and determining the extent of equitable relief. However, this is a dangerous course to follow, because, at its most extreme, it dislocates equitable proprietary relief from equitable doctrine altogether. The work of some modern restitution lawyers highlights this trend very clearly. In order to succeed, these theorists have subsumed areas of traditional equitable jurisprudence into the law of restitution and they have also sought to identify equitable proprietary mechanisms which have restitutionary characteristics.<sup>11</sup> The results of their analyses are highly innovative and interesting schemes in which the rationale for equitable intervention is carved out of the proprietary shell which is then filled with restitutionary rationalisations. Moreover, such analysis may torture and recast traditional proprietary modes beyond recognition. Thus, the situation remains inherently confused and unsatisfying. One is left wondering whether a simpler and more coherent scheme is possible.

A fourth approach is that equitable intervention is available when a judge considers that it is necessary to redress the perceived unconscionable conduct (or unjust enrichment) of the insolvent or unconscionable outcome. Unconscionability operates as an abstract concept upon which both the decision and outcome of the case is rationalised. The danger is that insolvency administration is determined on the basis of a subjective interpretation of unconscionability. Therefore, equitable intervention may be piecemeal and *ad hoc*. Certainty of principle and predictability is impossible where unconscionability is an abstract standard.

The fifth interpretation stresses that it is no longer possible to adhere to traditional modes of equitable relief or to torture such traditional modes beyond

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<sup>10</sup> [1996] AC 669.

<sup>11</sup> See for example Peter PH Birks, 'Equity in the Modern Law: An Exercise in Taxonomy' [1996] 26 *The University of Western Australia Law Review* 1; Robert Chambers, *Resulting Trusts* (1997).

recognition in order to reach a satisfactory outcome. Rather, it is necessary to identify the *raison d'être* of modern equity. Equity no longer operates on the basis of an ecclesiastical or canonical notion of subjective conscience (although some important modern equitable mechanisms such as the trust were the product of the ecclesiastical conscience). Instead, as society became secularised, so did equity. Moreover, as commercial certainty was required, so too equity abandoned subjective notions of conscience in favour of objective standards. In addition, the operation of modern equity in commercial relationships is explicable on the basis of risk assumption. As discussed in Chapter 2, commercial risk assumption may explain the operation of trusts, some fiduciary relationships and undue influence because there has been no assumption of risk of insolvency by a beneficiary or a party upon whom undue influence has been exercised. It would be the unconscionable conduct of the insolvent which would (without equitable intervention) cause the unsecured status of the beneficiary or unduly influenced party. It is for this reason that equity intervenes and provides proprietary relief.

The possibility of a coherent scheme for equitable intervention beyond traditional bases is enhanced by the adoption of commercial risk assumption as a rationale. The underlying assumption of the modern capitalist system is that parties bear the risks and consequences of the commercial relationships they enter. Therefore, such parties must take their own initiative to minimise any potential risks of the transaction including the potential insolvency of the other party. The fundamental premise of this essentially *laissez-faire* thinking is that parties will act self-interestedly, but honourably. However, this is a flawed assumption. Self interest and high-minded conduct are not always compatible with commercial conduct. Therefore, even in the *laissez-faire* heyday of the 19th century, equity was compelled to impose fiduciary obligations and develop equitable doctrines such as subrogation. Equity intervened to protect parties who placed trust and confidence in commercial advisers and operators. Equity also intervened to prevent unconscionable 'advantage-taking' of vulnerability and special disadvantage. As modern transactions and technology have become more complex, the need for equitable proprietary intervention has not abated. Rather, it is increasingly obvious that equitable proprietary intervention can no longer be limited to traditional equitable relationships or to protect innately vulnerable persons. As the discussion in Chapter 6 has indicated, business persons may legitimately call upon equity to intervene in commercial transactions. The development of the constructive trust as a remedy in various jurisdictions also supports the need for equitable intervention. Such situations may be more limited or less frequent than the traditional areas of equitable relief - but they are no less real.

The theory of objective non-assumption of risk represents a co-joining of the general rationale for equitable intervention together with the rationale for equitable proprietary intervention, non-assumption of risk. In Chapters 5, 6 and 7, the theory of objective non-assumption of risk was developed and applied as an explanation of why and how equity intervenes in certain commercial transactions and not in others. It has been contended that the theory may be used as a modern and coherent rationale for the continued efficacy of equity's traditional mechanisms such as the trust or fiduciary obligations. However, its operation was considered in essentially commercial transactions concerned with the transfer and receipt of money, many of which do not fall within equity's traditional purview. Central to the theory is that it is the conduct of the insolvent which has placed the creditor in an unsecured position; and, objectively speaking, the creditor could not have been expected to avoid or minimise the risks associated with the transaction.

#### **IV THE OPERATION OF EQUITY IN THE 21ST CENTURY**

Having identified a modern rationale for equitable proprietary relief and developed a theory of objective non-assumption of risk, the question is - what does the theory show about the future possible direction of equity in the 21st century? It is submitted that the theory indicates that there will be substantial shifts in the way that equity operates in commercial relationships and insolvency administration. It also portends that important further policy issues will need to be addressed.

Indeed, the theory demonstrates a number of possible trends which are likely to radically change the way we perceive how equitable proprietary relief ought to operate in insolvency administration.

The theory of objective non-assumption of risk indicates that the so-called law of restitution may be simply part of a broad concept of equitable unconscionable conduct. As was shown, the concept of unconscionable conduct in equity has been wider than some commentators and judges have suggested, with the result that the modern law of restitution is probably part of the law of equity - or at least is explicable on equitable terms and objective non-assumption of risk. The advantage of such a common rationale for equitable proprietary intervention would be the development of a single doctrinal system for equitable proprietary relief.

Thus, if it were accepted that the concept of unconscionable conduct is broader than some commentators and judges have envisaged, the unnecessary divide



within equity between 'unjust enrichment' and 'unconscionability' would begin to disappear. As Tipping J stated in *Lankow v Rose*:<sup>12</sup>

The various roads which have been identified have different signposts, but...they all lead to Rome.<sup>13</sup>

Instead, the focus would be upon determining whether there had been an objective non-assumption of risk.

The theory of objective non-assumption of risk also signals that the supposed hard line between proprietary and personal remedies is breaking down. For some authors, such a prospect is troublesome.<sup>14</sup> However, more than fifty years ago, Noyes recognised that the development of the specific lien had precisely that effect.<sup>15</sup> In certain circumstances, equity provided proprietary relief to parties who would have otherwise had only recourse to personal relief under the contract.<sup>16</sup> What is occurring is that equity is beginning to develop a general approach to proprietary relief in contractual and bilateral relationships.<sup>17</sup> However, such a general approach is neither unprincipled nor untrammelled.

Another related aspect to the breakdown of the divide between proprietary and personal relief is that, at least in relation to money, the pre-condition of a proprietary base for proprietary relief is increasingly untenable. Technological innovation increasingly precludes a practical fulfilment of the condition. As presaged by the swollen assets theory, the nexus between 'property' and proprietary claims will become less important; and traditional personal actions may ground proprietary relief in cases where there has been an objective non-assumption of risk.

As the case law and this thesis already demonstrate, outside traditional equitable relationships and remedies, equity does not and cannot operate on a rule

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<sup>12</sup> [1995] 1 NZLR 277.

<sup>13</sup> Ibid, 293.

<sup>14</sup> David S Cowan, Rod Edmunds and John Lowry, 'Equitable Tracing and Swollen Assets Theory' (1995) 1 *Contemporary Issues in Law* 1.

<sup>15</sup> C Reinold Noyes, *The Institutions of Property: A Study of the Development, Substance and Arrangement of the System of Property in Modern Anglo-American Law* (1936) 370. Note also Sykes and Walker, above n 7, 8.

<sup>16</sup> Chapter 2, 73-75.

<sup>17</sup> See also *Muschinski v Dodds* (1985) 160 CLR 583, 612-616 (Deane J).

based scheme. A rule based scheme is, arguably, certain. But, it may lack an inherent flexibility to respond to a changing world and may preclude equitable proprietary intervention. Thus, traditional rules are beginning to break down. Equity will be called upon to intervene in commercial relationships where there is no formal fiduciary obligation and the funds in dispute are no longer traceable. It is suggested that equitable intervention will be based on two contextual factors. First, there will be an evaluation of the conduct of an insolvent in the light of the principle of unconscionability. Such a principle is not legally abstract. It has real meaning because various kinds of unconscionable conduct have been identified in the case law. However, it is not rigid. It is possible that new forms of unconscionable conduct may be identified by courts in the future. Secondly, equity will also consider the market context of the commercial transaction and the capacity of the creditor to avoid or minimise risk. Therefore, equity is moving from a proprietary jurisdiction constructed on set relationships and rules towards a proprietary jurisdiction based on the appraisal of conduct against general and flexible criteria.

However, when equity does intervene in commercial relationships, it must do so more sensitively than previously. It has been argued that in most circumstances, the constructive trust is not the appropriate response to unconscionable conduct where money is concerned. Rather, it has been posited that equitable proprietary relief needs to take the form of security rather than a trust. If this suggestion were followed, the equitable lien rather than the constructive trust would become the main form of proprietary relief where money was in dispute.

Another related area requiring sensitive judicial analysis is the award of interest where proprietary claims are made.

If equitable proprietary intervention expands the way posited, an interesting issue will be the extent to which the rule in *Barnes v Addy*<sup>18</sup> will remain relevant. In the past, where assets have not been traceable in the hands of a wrongdoing insolvent, if it has been possible to locate the assets in the hands of the third party who knowingly received them or knowingly assisted in the breach of fiduciary duty.<sup>19</sup> The meaning of 'notice' remains a problematical issue.<sup>20</sup>

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<sup>18</sup> (1874) LR 9 Ch App 244.

<sup>19</sup> *Westpac Banking Corporation v Savin* [1985] 2 NZLR 41; *Lankshear v ANZ Banking Group (New Zealand) Ltd* [1993] 1 NZLR 481.

The theory of objective non-assumption of risk may affect the demand for third party liability in two ways. First, if a proprietary base is no longer required as a pre-condition for proprietary relief, an aggrieved creditor may succeed against the insolvent on the basis of objective non-assumption of risk without the need to investigate the conduct of third parties. Therefore, the creditor's action would be refocussed on the conduct of the insolvent rather than whether or not a third party had notice of wrongdoing. Secondly, where the insolvent has insufficient assets to cover the creditor's claim, the question would be whether the creditor would be able to bring an action against a third party, such as a bank. The theory of objective non-assumption of risk operates beyond the boundaries of traditional equitable obligations, such as receipt of property subject to fiduciary obligations or knowingly assisting a breach of fiduciary obligations which are pre-conditions to relief under *Barnes v Addy*.<sup>21</sup> If third parties (who did not owe fiduciary obligations) were liable because they had notice of the insolvent's unconscionable conduct when they received the assets or assisted the insolvent, then the concept of notice would have to be more clearly defined than it is at present.

Finally, previous attempts to adapt pre-existing equitable proprietary mechanisms, such as fiduciary obligations or the resulting trust, have tended to obscure important policy issues which lie ahead. Here the issue is how far should the broad principle of unconscionable conduct traverse insolvency schemes. It was noted earlier in this chapter that the bifurcation of creditors, according to whether they are secured or unsecured, is helpful but sometimes inadequate. Yet, at the heart of insolvency administration is the assumption that unsecured creditors are entitled only to a rateable distribution of the assets which are not subject to securities. This thesis has demonstrated that the rateable distribution principle is and ought to be inapplicable to certain kinds of creditors, namely, those creditors who did not objectively assume the risk of being an unsecured creditor. It was argued in Chapter 7 that such creditors should be granted proprietary relief to enable them to stand ahead of other unsecured creditors. However, the extent to which a creditor affected by the unconscionable conduct of the insolvent, should stand ahead of unsecured creditors is contentious. From a purely equitable perspective, unconscionable conduct should be addressed by appropriate remedial relief including, where

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<sup>20</sup> See for example *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 378; *Baden v Société Générale pour Favoriser le Développement du Commerce et de l'Industrie en France SA* [1983] BCLC 325; [1992] 4 All ER 161.

<sup>21</sup> See for example *Consul Development Pty Ltd v DPC Estates Pty Ltd* (1975) 132 CLR 373.

necessary, proprietary relief. However, the operation and effect of proprietary relief (whether in the form of the remedial constructive trust or a general equitable lien) could impede the effective operation of traditional securities. The interest of a constructive beneficiary or a general lienholder may take priority over established security holders. As the Privy Council in *Re Goldcorp Exchange Ltd (In Receivership)*<sup>22</sup> indicated, it is unclear how courts will proceed. Whilst equity is able to intervene and modify the effect of the statutory scheme, the kind of modification inherent in the remedial constructive trust and the general equitable lien may question the underlying thrust of insolvency schemes such as the *Bankruptcy Act 1966* (Cth). Therefore, not only judges, but also insolvency policy makers, need to reconsider the integral status of secured creditors vis-à-vis unsecured creditors who seek relief due to an objective non-assumption of risk.

As stated at the beginning of this thesis, one of the most difficult issues facing commercial and insolvency lawyers of the late 20th century is defining the circumstances in which proprietary relief is available to unsecured creditors of insolvents. The tortured and uncertain path towards resolution of this issue has been the result of legacies of the 19th century and the imperfect and incoherent way our legal system has regulated the blemishes of an otherwise untrammelled laissez-faire capitalist system. However, as this thesis propounds, a resolution of this issue lies in an investigation of the nature of equity's capacity to provide proprietary relief. It is predicted that lawyers in the 21st century will re-affirm that the award of proprietary relief (in whatever form it takes) is and will remain part of equity's domain.

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<sup>22</sup> [1995] 1 AC 74, 104 (Lord Mustill).

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